



Alternative Investment Fund Managers (Category - I and II)



Workbook for
NISM-Series-XIX-D: Category I and II Alternative
Investment Fund Managers
Certification Examination

National Institute of Securities Market

www.nism.ac.in

This workbook has been developed to assist candidates in preparing for the National Institute of Securities Markets (NISM) Certification Examination for Category I and II Alternative Investment Fund Managers.

Workbook Version: April 2025

Published by:

National Institute of Securities Markets

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NISM supports candidates by providing lucid and focused workbooks that assist them in understanding the subject and preparing for NISM Examinations. This book covers basic understanding of the investment landscape, alternative asset classes, alternative investment funds in India, roles and functions of various stakeholders in AIF. The book also discusses, in depth, about the due diligence, governance, monitoring and reporting processes followed by Category I and II AIFs. It also provides an understanding of the role of Investment Managers and their team in performing various activities regarding fund management. The book further emphasises on valuation techniques, investment strategies, performance evaluation along with benchmarking policies adopted by Category I and II AIFs. The taxation aspects and related regulations to be adhered to by the Category I and II AIFs in India have also been discussed in the workbook.

Sashi Krishnan
Director, NISM

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Acknowledgement

This workbook has been developed jointly by the Certification team of National Institute of Securities Markets (NISM), Archit Lohia, Dr. Pratap Giri and Dr. Rachana Baid; and reviewed by Biharilal Deora and Taxmann Publications Pvt Ltd, NISM empanelled Resource Persons.

NISM gratefully acknowledges the contribution of the Examination Committee of NISM-Series-XIX-D: Category I and II Alternative Investment Fund Managers Certification Examination consisting of industry experts.

About NISM Certifications

NISM is engaged in developing and administering Certification Examinations and Continuing Professional Education (CPE) Programmes for professionals employed in various segments of the Indian securities markets. These Certifications and CPE Programmes are being developed and administered by NISM as mandated under Securities and Exchange Board of India (Certification of Associated Persons in the Securities Markets) Regulations, 2007.

The skills, expertise and ethics of professionals in the securities markets are crucial in providing effective intermediation to investors and in increasing the investor confidence in market systems and processes. NISM seeks to ensure that market intermediaries meet defined minimum common benchmark of required functional knowledge through Certification Examinations and CPE Programmes on Mutual Funds, Equities, Derivatives, Securities Operations, Compliance, Portfolio Management etc.

These Certifications create quality market professionals and catalyzes greater investor participation in the markets. They also provide structured career paths to students and job aspirants in the securities markets.

About the Certification Examination for Category I and II Alternative Investment Fund Managers

This examination seeks to create a common minimum knowledge benchmark for Category I and II AIF Managers and its key investment team. The examination focuses to enhance the quality of fund management activities in the AIF space and enables a better understanding of features of AIF products, investment valuation norms, fund governance processes, fund performance measurements, taxation aspects and related regulations. The examination is focused on fund management aspects relating to Category I and II AIFs.

Examination Objectives

On successful completion of the examination the candidate should:

- Know briefly about the investment landscape and various types of investments (traditional and alternative asset classes).
- Understand the following in detail pertaining to managing of AIFs:
 - Suitability of AIF products and its role in portfolio diversification
 - AIF ecosystem, role of its various service providers
 - Role of Managers of AIFs and their key management team in performing fund management duties, governance of funds, managing conflict of interests etc.
 - Fund structure, fee structure, performance measurement techniques and its interpretations, importance and role of performance benchmarking
 - Various investment strategies involved, investment due diligence processes and governance structure in AIFs followed by investors
 - Code of Conduct of AIFs, Manager of AIFs and their key management team etc.
 - Legal documentations involved and importance of negotiations among stakeholders in AIF domain
 - Valuation techniques used, role of third-party registered valuers, fund monitoring and reporting
 - Various exit options available to AIFs
 - Various taxation aspects for the fund and its investors
- Know the regulatory environment in which the AIFs operate in India, such as SEBI (AIF) Regulations, FEMA, PMLA, SEBI (PIT) Regulations, SEBI (PFUTP) Regulations etc.

Assessment Structure

The examination consists of 60 multiple-choice questions and 4 case-based questions (each Case having 5 sub-questions). The assessment structure is as follows:

Multiple Choice Questions [60 questions of 1 mark each]	$60 \times 1 = 60$
Case-based Questions [4 cases (each case with 5 questions of 2 mark each)]	$4 \times 5 \times 2 = 40$

The examination should be completed in 2 hours. The passing score for the examination is

60% i.e. 60 marks out of 100. There shall be negative marking of 25 percent of the marks assigned to a question.

How to register and take the examination

To find out more and register for the examination please visit www.nism.ac.in

Important

- Please note that the Test Centre workstations are equipped with either Microsoft Excel or OpenOffice Calc. Therefore, candidates are advised to be well versed with both of these softwares for computation of numericals.
- The sample caselets and multiple-choice questions illustrated in the book are for reference purposes only. The level of difficulty may vary in the actual examination.

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Chapter-wise Weightages

Chapter No.	Chapter Name	Marks Allocated
1	Investments Landscape	2
2	Types of Investments	
3	Alternative Investment Funds in India and its Suitability	2
4	Alternative Investment Funds Ecosystem	5
5	Alternative Investment Fund Structuring	10
6	Fee Structure of AIFs	10
7	Fund Performance and Benchmarking of AIFs	10
8	Legal Documents and Negotiations	6
9	Investment Strategies	10
10	Investment Process and Governance of Funds	10
11	Valuation	10
12	Fund Monitoring, Reporting and Exit	10
13	Taxation	5
14	Regulatory Framework	10
Total Marks		100

Section A: Basics of Investments

CHAPTER 1: INVESTMENTS LANDSCAPE

LEARNING OBJECTIVES:

After studying this chapter, you should understand about:

- Meaning of Investments
- Difference between saving and investment
- Difference between investment and speculation
- Objectives of investments
- Components of required rate of return
- Relationship between risk and return
- Types of risks
- Overview of Indian Securities Markets

1.1 Investment

People earn money and spend money. They pass through various phases in their life cycle. During some phases, they earn more money than they spend. In other phases, they earn less than they spend. Therefore, sometimes they have to borrow money to meet the shortfall and in other times they end up having surplus money.

People have, broadly, two options to utilise their savings. They can either keep it with them until their consumption requirements exceed their income, or, they can pass on their saving to those whose requirements exceed their income with the condition of returning it back with some increment. Therefore, those who consume more than their current income must be willing to repay more than what they received, to those who have provided the funds. Essentially, people make a trade-off between postponing their current consumption, and an expected higher amount for future consumption.

1.1.1 Saving versus Investment

It is common to use the terms Savings and Investment interchangeably. However, they are not one and the same. Saving is just the difference between money earned and money spent. Investment is the current commitment of savings with an expectation of receiving a higher amount of committed savings. Investment involves some specific time period. It is the process of making the savings work, viz investment to generate return.

Hence when people are saving, they may save in variety of instruments or securities like cash or gold but mostly they use the short-term deposits/short-term securities which are highly liquid assets. On the other hand, when people are investing they commit funds to specific asset classes or goals with longer term time horizon like real assets, capital market securities

such as stocks and bonds, and other long-term commitments that may not be as liquid as short-term assets. See Box 1.1 to understand the difference between Financial and Real assets. Secondly, the objectives of savers and investors are different. Savers tend to accumulate funds to address short-term goals, whereas investors have longer-term goals, such as building retirement corpus or funding children's college education expenses. Those who save funds have the choice of investing. Hence, every investor is a saver but not vice versa.

Box 1.1: Financial Assets versus Real Assets

Assets can broadly be categorised as **financial assets** such as shares, debentures, bank deposits, public provident fund, mutual fund investments and others, and real or **physical assets (tangible assets)** such as gold, diamonds, other precious metals, infrastructure and real estate. Financial assets have the advantage of greater liquidity, flexibility, convenience of investing and ease of maintaining the investments. They are primarily income generating investments, though some of them, such as equity-oriented investments are held for long-term capital appreciation. There is greater ease of investing in such assets as it allows for small and frequent investments.

1.2 Investment versus Speculation

Another term which needs to be distinguished from “Investment” is “Speculation”. Investment and speculation activities are so intermingled that it is very difficult to distinguish and separate them. An attempt can be made to distinguish between speculation and investment on the basis of criteria like investment time horizon and the process of decision making.

Financial transactions occur on a time continuum ranging micro milli-second, micro-second, second, minute, hour, day, week, month, year, decade, century and perpetual time period. There is a tendency to describe short-term activities as speculative in nature and long-term ownership of assets as investments, which is not appropriate.

Another popular way to define speculation is by extending the dictionary meaning of the same. Dictionary meaning of the term speculation is “the forming of a theory or conjecture without firm evidence”. The activity of investment involves carrying out any exercise or process to determine the value of the asset and then buying the one whose value is determined to be higher than the current market price. However, while speculating, one is motivated to undertake risk which is not commensurate with the return, in anticipation of gaining higher returns, with minimum research and analysis on the true value of the asset.

1.3 Investment Objectives

Most of the investors invest with a goal in mind, regarding the value of the investment at the end of the investment period. Investment objectives are investors' goals expressed in terms of risk, return and liquidity preferences. Some investors may have the tendency to express their goals solely on the basis of return. They must be encouraged to state their goals in terms of both risk and return, as expressing goals only in terms of return may lead to inappropriate asset allocation and adoption of risky investment strategies. Given to themselves, an investor may want her wealth to double up by the end of the year. However, she must be made to understand that such a goal would entail excessive risk. The investor must be explained that "risk leads return" and not the other way around. Hence a detailed analysis of the risk appetite of the investor i.e. her willingness and ability to take the risk should proceed any discussion of the desired return.

The return objective may be simplified as follows:

Capital Preservation means minimizing or avoiding the chances of erosion in the principal amount of investment. Highly risk averse investors pursue this investment goal, as this investment objective requires no or minimal risk taking. Also, when funds are required for immediate short term, investors may state for capital preservation as the investment objective.

Capital Appreciation is an appropriate investment objective for those who want their portfolio value to grow over a period of time and are prepared to take risks. This may be an appropriate investment objective for long term investors.

Regular Income is an investment objective pursued when investor wants her portfolio to generate income at regular interval by way of dividend, interest, rental income rather than appreciation in the value of the portfolio. This investment objective is mostly pursued by people who are retired and want their portfolios to generate income to meet their living expenses.

Tax Saving: Sometimes investors do invest in some select investment alternatives, to reduce their tax burden. This is because the IT authorities provide tax benefits in terms of deductions from taxable income, or as tax rebate from the tax payable.

1.4 Estimating the required rate of return

Investment is the commitment of rupee for a period of time to earn a) pure time value of money – for investors who postpone their current consumption b) compensation for expected inflation during the period of investment for the change in the general price levels and c) risk premium for the uncertainty of future payments.

The price paid for the exchange between current and future consumption is the pure rate of interest. If an investor postpones consumption worth INR 1000 today for a guaranteed

future consumption worth INR 1020 then the pure rate of interest in this exchange is 2%. $((1020-1000)/1000)$.

It is the rate of return, the investor demands even if there is no inflation and no uncertainty associated with future payments. In reality, price level rarely remains the same. Hence, if an investor expects a rise in the price level, they will require an additional return to compensate for it which is also known as inflation. Further, if there is a risk associated with future payment, investor will demand compensation for bearing the risk.

The compensation for postponement of consumption is the pure time value of money. It is referred as real risk-free rate. Real risk-free rate when adjusted for inflation expectation is referred as nominal risk-free rate. Nominal risk-free rate plus risk premium is the required rate of return.

Real risk free rate plus inflation adjustment + Risk premium adjustment = Required rate of return. Required rate of return is the minimum rate of return investors expect when making investment decisions. It is to be noted that required rate of return is not guaranteed return or assured return. It is also different from expected or forecasted return. It is also different from realised return. It's a rate of return which an investor is looking in return from any investment he makes.

1.4.1 Nominal risk-free rate, real risk-free rate, and expected inflation

The notion that money has time value is a fundamental concept in investments. It is the central theme in calculating the rate of return. It is better to receive a sum of money today than to receive the same sum tomorrow because it can be invested today and earn returns for tomorrow. Investors can invest in investment opportunities like risk-free bonds, where they are promised to receive an amount more than the amount they have invested.¹ For example if an investor invests INR100 today at a risk-free rate of 5% per year, the value of this investment at the end of one year will be $\text{INR}100 + (\text{INR}100 \times 5\%) = \text{INR}105$. Thus, INR105 is the future value of this current investment, one year from now. The value today is its present value. i.e. INR100. Conversely, if an investor is certain of receiving INR105, one year from today, then its present value can be calculated as $\text{INR}105 / (1+5\%) = \text{INR}100$. These calculations substantiate an old age saying that “a dollar today is worth more than a dollar tomorrow”, or one needs more money to buy something tomorrow, than what it needs today.

The certainty of receiving the amount in future makes it a risk-free investment. And the rate of return on the same is called a risk-free rate. In this case it is 5%. This risk-free rate is also referred as nominal rate of return. As can be seen, it ignores the potential change in the

¹An investment avenue where there is certainty of receiving the promised amount in future. Example of risk-free investment is treasury (government) bond.

purchasing power of the rupee. That is, though the investor is certain of receiving INR105 after one year, there is no guarantee that rupee will have the same purchasing power a year from now that it has today. From the nominal rate, inflation rate can be subtracted to calculate the real rate of return.

Hence Nominal rate of return can be decomposed into: real rate of return and inflation rate.

Real risk-free rate is the basic rate of return or interest rate, assuming no inflation and no uncertainty about future cashflows. It is the compensation paid for postponing the consumption.

For example, an investor gives up INR 100 today for more than INR 100 say INR 102 one year from today. If this is a risk-free investment and the real risk-free rate of interest is 2% $((102/100) - 1)$. The desire for current consumption influences this rate. The desire for current consumption is influenced by the investment opportunities available in the economy. The availability of investment opportunities is determined by the real growth rate of the economy. Hence, the real risk-free rate is determined by an interaction between subjective factors like the desire for consumption and objective factors like the available investment opportunities and the growth rate of the economy.

As noted above, if investors expect the price level to rise during the period of investment, they would require a compensation for the expected rate of inflation. Continuing with the above example, "What if the price level in the economy increases by 6%?" In such situation, the investors should increase the required rate of return by the expected rate of inflation. If they do not do so, then they would be losing money in the real sense rather than getting a real rate of return. To maintain a consumption of INR102, the interest earned must be 8.12 per cent. The required nominal rate of return (NRR) would be as follows:

$$\text{NRR} = [(1 + \text{Real rate of return}) \times (1 + \text{Expected rate of inflation})] - 1$$

$$8.12\% = [(1 + 2\%) \times (1 + 6\%)] - 1$$

Thus, 8.12% rate of return is required in place of 2%. This rate of interest (comprising real rate of return plus the compensation for inflation compensation) is called the nominal rate of return. It is also considered as the nominal risk-free rate of return.

1.4.2 Risk Premium

As discussed above, the nominal risk-free rate of return is the rate of return, an investor is certain of receiving on the due date. Investor is certain of the amount as well as the timing of the return. Hence, it is the risk-free rate of return. Some investment opportunities such as government securities (with some caveats) fit this pattern. The returns from most of the investment opportunities do not have certainty of the amount and the timing of cashflows. Further, the uncertainty of receiving the future cashflows vary amongst investments. In such cases, investors would require compensation for the uncertainty associated with future cashflows. This additional compensation over the nominal risk-free rate is called risk premium. If the investors perceive higher risk (more uncertainty with respect to the future payment), they would demand higher risk premium.

1.4.3 Types of risks

Risk is usually understood as “exposure to a danger or hazard”, however it is not exposure to danger, rather the variability in impact when exposed to a danger. In investment, risk is defined as the possibility that the actual earnings could be different from what is expected to be earned. In more technical terms, the dispersion around the average expected return is defined as risk.

Similarly, people use risk and uncertainty interchangeably. This also is not correct. Risk is not uncertainty. When one does not have any knowledge about the future variability in the expected outcomes or their causal factors, then such a situation is known as “uncertainty”. However, when there is some existing or developing theoretical or empirical knowledge about the factors leading to uncertainty, then such situation is considered as “risk”. In summary, Risk is known uncertainty. As research evidence or scientific advancements progress towards more clarity on the causal factors leading to some phenomena or event, then everyone begins to term that phenomenon as risk and no more uncertainty. There are various types of risk viz., business risk, financial risk, liquidity risk, political risk, exchange rate risk etc.

- **Business risk:** Variability of income flows caused by the nature of a firm’s business, is defined as business risk. Sales volatility and operating leverage determines the level of business risk. For example, an auto manufacturer incurs high operating costs viz-a-viz a retail food company. Earnings and sales of the auto manufacturer fluctuates substantially over the business cycle leading to high business risk.
- **Financial risk:** Financial risk relates to the means of financing the assets with either debt or equity. When a firm borrows, it is required to make fixed payments to be paid ahead of payments to stockholders. Thus, the use of debt increases the volatility of stockholder’s income. This increase in volatility because of use of fixed cost financing alternatives is referred to financial risk and also popularly known as financial leverage.
- **Liquidity risk:** Liquidity has multiple connotations in the realm of finance. One such connotation is the ease of converting an asset into an amount of cash, nearer to its economic worth. The more difficult the conversion, the more is the liquidity risk. Liquidity risk is the uncertainty introduced by the secondary market of an investment. Treasury bills have almost no liquidity risk. They can be sold in a fraction of minute at a price worth their economic value. On the other hand, a piece of art may take longer to get converted into cash and the price may deviate significantly from its worth.
- **Exchange rate risk:** Exchange rate risk is the volatility of return introduced by acquiring investments denominated in a currency different from that of the investor. Changes in exchange rates affect the investors return when converting an investment back into the “home” currency. As more and more investors want to reap the benefits of a globally diversified portfolio, this risk increases. As an example, suppose that an Indian investor purchases a dollar denominated bond. On such bond, interest will be paid in dollar. If the rupee has appreciated in value compared to USD,

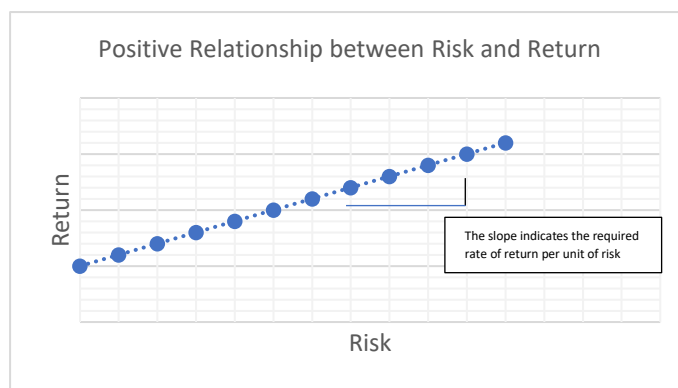
when the interest is received in dollar and converted into rupee, the investor will receive less in rupee than expected. The risk in this entire episode is arising due to the unpredictability of volatile and uncontrollable currency exchange rates.

- **Political Risk:** Political risk is the volatility of returns caused by the possibility of a major change in the political or economic environment in a country. Individuals who invest in countries that have unstable political-economic systems must include an additional country risk-premium when determining their required rate of return.
- **Geopolitical Risk:** Geopolitics is influence of geography and politics on the social and economic relationships between countries. Geopolitical risk is the risk associated with wars, terrorist acts, and tensions between states that affect the normal and peaceful course of international relations. An example of geopolitical risk could include a flare-up of tensions between China and USA and how it has impacted the global trade and economy. Another example is the border tensions between India and China that escalated in May 2020.
- **Regulatory Risk:** Regulatory risk is the risk associated with unpredictability about the regulatory framework pertaining to investments. It is the risk that existing regulations will become more stringent leading to higher transaction costs. Regulatory risk is higher in new investment opportunities and products than the matured and established ones.
- **Market Risk:** Market risk is defined as the possibility of a financial loss arising from movements in the demand-supply position in financial markets that tend to fluctuate the prices of financial assets. Financial markets are susceptible to various external factors such as exchange rate and interest rate movements, level of liquidity in the market, flow of funds from other markets and so on. These movements affect the demand and supply for financial assets which causes market risk.
- **Interest Rate Risk:** Interest rate risk is the possibility of a loss of return to an investor in a debt instrument due to the reduction in its value. This would happen when there is a rise in interest rates due to which existing debt instruments carrying a lower rate of interest would drop down in their value.
- **Country risk:** Country risk is an additional dimension in international investing which is associated with the differences in various geographies and the associated political and macroeconomic risk factors. These risks are considered to be additional variables in computing risk premium associated with international investing as compared to investing in domestic markets. Accordingly, investors seek an additional country risk premium (CRP) which is usually considered higher for developing countries with higher growth and inflation rates as compared to developed countries. CRPs can be computed specific to each country by using the credit default spreads on sovereign bonds of developed countries such as the US as benchmarks.

1.4.4 Relationship between risk and return

Exhibit 1.1 plots the usual relationship between risk and return. A positive relationship exists between risk and return. The greater the risk, the higher the return. The graph demonstrates that investors increase their required rate of return as their expectation about future volatility of returns increases. As a result, the risk premium goes up. The graph is just to convey the meaning of a positive relationship, however, in reality, the relationship between risk return is nonlinear, that is there is no proportionate increase in return for every unit increase of risk. Similarly, this graph is also different for different individuals, due to their risk appetite or risk aversion.

Exhibit 1.1 Relationship between risk and required rate of return²



1.4.5 Overview of Indian Securities Markets

The securities market provides an institutional structure that enables a more efficient flow of capital in the economy. The savings of household can be deployed to fund the capital requirement of a business enterprise, through the securities markets. The businesses issue securities, raise money from the household through a regulated contract, list the securities on a stock exchange to ensure that the security is liquid (can be sold when needed) and provides information about its activities and financial performance to the household. This basic arrangement in the securities markets enables flow of capital from households to business, in a regulated institutionalised framework.

The term “securities” has been defined in Section 2 (h) of the Securities Contracts (Regulation) Act 1956. The Act defines securities to include:

²Chapter 1, An overview of Investment Process, Analysis of Investments and Management of Portfolios, Reilly & Brown, 10th edition

- a) shares, scrips, stocks, bonds, debentures, debenture stock or other marketable securities of a like nature in or of any incorporated company or a pooled investment vehicle or other body corporate;
- b) derivative³;
- c) units or any other instrument issued by any collective investment scheme to the investors in such schemes;
- d) security receipt as defined in clause (zg) of section 2 of the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002;
- e) units or any other such instrument issued to the investors under any mutual fund scheme (securities do not include any unit linked insurance policy or scrips or any such instrument or unit, by whatever name called which provides a combined benefit risk on the life of the persons and investment by such persons and issued by an insurer referred to in clause (9) of section 2 of the Insurance Act, 1938 (4 of 1938);
- f) units or any other instrument issued by any pooled investment vehicle
- g) any certificate or instrument (by whatever name called), issued to an investor by any issuer being a special purpose distinct entity which possesses any debt or receivable, including mortgage debt, assigned to such entity, and acknowledging beneficial interest of such investor in such debt or receivable, including mortgage debt, as the case may be;
- h) government securities;
- i) such other instruments as may be declared by the Central Government to be securities (including onshore rupee bonds issued by multilateral institutions like the Asian Development Bank and the International Finance Corporation, electronic gold receipts, zero coupon zero principal instruments);
- j) rights or interest in securities.

A security represents the terms of exchange of money between two parties and thereby represents a financial claim by the holder of the security against the issuer of such security. Securities are issued by companies, financial institutions or the government. They are purchased by investors. Security ownership allows investors to convert their savings into financial assets which provide a return. The issuers of securities are able to reach out to a broader group of investors. For example, in the absence of a well-developed securities market, a household with surplus fund may have to hold all of their savings in a bank deposit even if they are willing to take on some risk for higher returns. But with the different types of equity and fixed income securities available with varying levels of risk and return, investors can choose to invest their surplus funds in the type of security that suits their

³As per SCRA, derivatives includes a security derived from a debt instrument, share, loan, whether secured or unsecured, risk instrument or contract for differences or any other form of security; a contract which derives its value from the prices, or index of prices, of underlying securities; commodity derivatives; and such other instruments as may be declared by the Central Government to be derivatives. [Amended by the Finance Act 2017]

specific preferences. Thus, the objectives of the issuer and the investor are complementary and the securities market provides a vehicle to mutually satisfy their goals.

The issuer of the security provides the terms on which the capital is being raised. The investor in the security has a claim to the rights represented by the securities. These rights may involve ownership, participation in management or claims on assets.

The market in which securities are issued, purchased/sold by investors and subsequently transferred among investors is called the securities market.

1.4.5.1 Primary and Secondary Markets

The securities market has two interdependent and inseparable segments, viz., the primary market and the secondary market. The primary function of the securities market is to enable the flow of capital from the pockets of savings, with idle or surplus resources to the pockets with deficit of resources but rich with productive ideas. To state formally, securities market provides channels for conversion of savings into investments and back. The investors in the Indian securities market have a wide choice of financial products to choose from depending upon their risk appetite and return expectations.

The securities market has two interdependent and inseparable segments:

Primary Market: The primary market, also called the new issue market, is where issuers raise capital by issuing securities for the first time to the investors. Primary market offerings may be a public offering or an offer to a select group of investors in a private placement program. The shares offered may be new shares issued by the company, or it may be an offer for sale, where an existing large investor/investors or promoters offer a portion of their holding to the public.

Secondary Market: The secondary market facilitates trades in the securities that are already-issued in the primary markets, thereby enabling investors to exit from an investment or new investors to buy the already existing securities. An active secondary market promotes the growth of the primary market and capital formation, since the investors in the primary market are assured of a continuous market where they have an option to liquidate or exit their investments.

The primary market facilitates creation of financial assets, and the secondary market facilitates their marketability/tradability which makes these two segments of Financial Markets - interdependent and inseparable. Thus, in the primary market, the issuers have direct contact with the investors, while in the secondary market, the dealings are between investors only.

1.4.5.2 Market Participants

Market Participants in securities markets include buyers, sellers and various intermediaries between the buyers and sellers. Some of these entities are discussed in brief below:

Market Infrastructure Institutions and other intermediaries:

- *Stock Exchanges:* Stock Exchanges provide a trading platform where buyers and sellers can transact in already issued securities. Stock markets such as NSE, BSE and MSEI are nationwide exchanges. Trading happens on these exchanges through electronic trading terminals which feature anonymous order matching. Stock exchanges also appoint clearing and settlement agencies and clearing banks that manage the funds and securities settlement that arise out of these trades.
- *Depositories:* Depositories are institutions that hold securities (shares, debentures, bonds, government securities, mutual fund units) of investors in electronic form. Investors open an account with the depository through a registered Depository Participant. They also provide services related to transactions in the securities held in dematerialised form. Currently there are two Depositories in India that are registered with SEBI—Central Depository Services Limited (CDSL), and National Securities Depository Limited (NSDL).
- *Depository Participant:* A Depository Participant (DP) is an agent of the depository providing depository services to the investors. Depository participants enable investors to hold and transact in securities in the dematerialized form. While the investor-level accounts in securities are held and maintained by the DP, the company level accounts of securities issued is held and maintained by the depository.
- *Trading Members/Stock Brokers:* Trading members or Stock Brokers are registered members of a Stock Exchange. They facilitate buy and sell transactions of investors on stock exchanges.
- *Custodians:* A Custodian is an entity that is vested with the responsibility of holding funds and securities of its large clients, typically institutions such as banks, insurance companies, and foreign portfolio investors. Besides safeguarding securities, a custodian also settles transactions in these securities and keeps track of corporate actions on behalf of its clients.
- *Clearing Corporation* - Clearing Corporation plays an important role in safeguarding the interest of investors in the Securities Market. Clearing agencies ensure that members on the Stock Exchange meet their obligations to deliver funds or securities. These agencies act as a legal counterparty to all trades and guarantee settlement of all transactions on the Stock Exchanges. It can be a part of an exchange or a separate entity. It is usually created as a subsidiary of a stock exchange to provide bankruptcy remoteness from the exchange.

- *Merchant Bankers*- Merchant bankers are entities registered with SEBI and act as issue managers, investment bankers or lead managers. They help an issuer access the security market with an issuance of securities and market such offers. Merchant bankers also act as the underwriters to the issue i.e. they provide a commitment to subscribe to the issue of securities in the event of failure of the issue to get full subscription from the public. They receive a commission for providing such commitment. Their obligations are defined in their agreement.
- *Registrars and Transfer Agents*: Registrars and Transfer Agents (RTAs) maintain the records of investors for the issuer for the purpose of ensuring title and other corporate/economic benefits such as dividends to flow to the legal owners of the securities. In the modern securities markets, the securities are held in a dematerialised form in the depository. The changes to beneficiary names are made automatically when a security is sold and delivered to the buyer. Investor records are maintained for legal purposes such as determining the first holder and the joint holders of the security, their address, bank account details and signatures, and any nominations they may have made about who should be receiving the benefits from a security after their death.

Investors:

Investors are individuals or organisations with surplus funds which can be used to purchase securities. The chief objective of investors is to convert their surplus and savings into financial assets that earn a return. Based on the size of the investment and sophistication of investment strategies, investors are broadly classified into Institutional Investors, Non-Institutional Investors and Retail Investors.

Institutional investors are organisations that invest large sum of money and employ specialised knowledge and investment skills. Institutional Investors comprises mutual funds, pension funds, insurance companies, hedge funds, alternative investment funds, foreign portfolio investors.

Non-institutional investor means any investor other than a retail investor and includes family offices, high networth individuals, ultra high networth individuals etc. Retail Investors include individual investors who buy and sell securities for their personal account, and not for another company or organisation. As per the SEBI Issue of Capital and Disclosure Requirements (ICDR) Regulations, 2018, 'Retail individual investor' means an individual investor who applies or bids for specified securities for a value of not more than INR 2 lakh.

Sample Questions: Chapter 1

1. The additional return required by the investor over and above the normal rate of return, when the investment is risky is called _____.
 - a) Alpha
 - b) Risk free rate of return
 - c) **Risk premium**
 - d) Both b & c

2. Future value of the investment is influenced by _____.
 - a) Time period
 - b) Rate of return
 - c) **Both a & b**
 - d) None of the above

3. Which of the following is the function of the secondary markets?
 - a) Provide liquidity for securities issued
 - b) Provide a platform for making public issues
 - c) Provide information about public companies
 - d) **All the above**

4. Which of the following is a distinguishing feature of primary market?
 - a) It originates securities into the market.
 - b) It enables issuers to raise capital.
 - c) It helps in intermediation between investors and issuers.
 - d) **All the above**

CHAPTER 2: TYPES OF INVESTMENTS

LEARNING OBJECTIVES:

After studying this chapter, you should understand about:

- Types of investment opportunities
- Channels for making investments

2.1 Traditional Investments Vs. Alternative Investments

Globally, alternative investment industry evolved over time, hence there is no uniform classification or limitation to what constitutes such assets. Alternative investments are therefore defined generally by several sources as investments other than traditional investments.⁴ Traditional investments (as distinguished from savings in bank deposits, government schemes, ornamental gold and residential property for living purposes) are confined to the domain of financial securities such as stocks and bonds from primary and secondary capital market, purchase of general categories of mutual fund units and Exchange Traded Funds (ETFs). Traditional investments cater to general investors who seek investment options which provide better returns than mere savings schemes.

Alternative investments evolved over time to cater to the requirements of sophisticated investors such as institutional investors managing pools of funds and High net-worth individual investors (HNIs) who have higher risk-taking capability and need more sophisticated avenues than traditional investment options. Unlike traditional investments, alternative investments are about investing in opportunities that can potentially generate higher returns but entail higher risk-taking as well. However, given their nature, alternative investments are only meant for risk-taking sophisticated investors who are either fund managers with institutional experience or portfolio managers for HNIs. Alternative investments are meant to complement traditional investments for such investors by improving their risk-adjusted returns over the long term (see Table 2.1).

⁴According to Investopedia, "An alternative investment is a financial asset that does not fall into one of the conventional investment categories. Conventional categories include stocks, bonds, and cash."

Table 2.1: Traditional and Alternative Investments – A comparative Listing

Traditional	Alternative	Dual
Public equities – listed stock	Private equity – direct investments in unlisted stock (privately held companies)	Closed ended debt funds with illiquid assets such as real estate exposures
Listed debt securities issued by both listed and unlisted companies	Direct investment in unlisted (rated or unrated) debt securities or loan capital	Exchange traded stable and predictable cash flow instruments such as Security Receipts issued by securitisation companies, Special Purpose Vehicles (SPVs), Asset Reconstruction Companies (ARCs)
Open ended mutual funds offering equity, debt or balanced exposures to listed debt, money market instruments and listed equity	Direct investments in real estate and infrastructure development Project SPVs	Units issued by Real estate Investments Trusts (REITs) and Infrastructure Investment Trusts (InvITs) offering stable cash flow and rating
Exchange traded simple derivative instruments such as futures & options used to manage portfolio risk on equities	Direct investment in commodities	Mutual funds with alternative or contrarian strategies that entail higher risk taking
Exchange traded funds (ETFs)	Hedge Funds, Complex structured products and derivatives such as Collateralised Debt Obligations (CDOs), Over-the-Counter derivatives Distressed Asset Funds that finance or acquire	

Traditional	Alternative	Dual
	companies in financial distress and Funds that invest in Special Situations such as Mergers & Acquisitions / hostile acquisitions / restructuring. These are complex corporate transactions where one company takes ownership control of another company or goes through a reorganisation of its assets and liabilities due to financial difficulties.	

As may be observed from Table 2.1, traditional investments are primarily on-market opportunities that whose common feature is liquidity, i.e. nearness to cash because they can be exited through the market or by anytime redemption offered by an open ended mutual fund.⁵ The essential characteristic of alternative investments is ‘illiquidity’, i.e. they are not readily convertible into cash as they are either off-market investments or because they are complex structures that do not have a ready market. The dual class could include structures that have underlying illiquid assets but the instruments per se may be liquid as they are either listed on the stock exchanges or are redeemable through the mutual fund route with some restrictions.

2.2 Types of Traditional Investments

There are many investment avenues. Broadly, investments can be classified into financial or non-financial investments. Non-financial investments include real estate, gold, commodities etc. Non-financial investments are also called Real Investments. Financial instruments are essentially claims on future cash flows. On the basis of claims on the cash flows, there are two generic types of financial instruments—debt and equity. Financial investments can also be classified on the basis of transferability of ownership in the secondary market, as security

⁵As mentioned earlier, traditional investments are primarily meant to provide high liquidity to investors through the capital market trading mechanism. Therefore, listed shares and bonds, units of mutual funds and exchange traded funds fit this requirement very well.

and non-security form of investments. Security form of investments, like shares, bonds, notes, etc., are easily transferable in the secondary markets. Whereas non-security form of investments like, fixed deposits, insurance, etc., cannot be transferable to any other investor and they do not have secondary markets. Security form of financial investments are actively traded on both capital and money markets.

2.2.1 Equity Shares

Equity Shares represent ownership in a company that entitles its holders a share in profits and the right to vote on the company's affairs. Equity shareholders are residual owners of firm's profit after other contractual claims on the firm are satisfied and they have the ultimate control over how the firm is operated. Investments in equity shares reward investors in two ways: dividend and capital appreciation.

Investments in equities have proven time diversification benefits and considered to be a rewarding long-term investment. Time diversification benefits refer to the notion that fluctuation in investment returns tend to cancel out through time, thus more risk is diversified away over longer holding periods. It follows that investment in equities offer better risk-adjusted return if held for long time periods. The concept of listed versus unlisted equity/ investments are explained in Table 2.2.

Table 2.2: Characteristics of Listed Equity Vs Unlisted Equity

Characteristic	Listed Equity	Unlisted Equity
Shareholding structure	Listed equity has a diversified shareholding pattern consisting usually of controlling shareholders a.k.a. promoters and their associates, institutional market investors, foreign investors and general public investors.	Unlisted equity is subscribed by the promoters of the company and their family who in many cases remain controlling shareholders a.k.a. promoters. Others may include promoter associates, alternative investment funds or high networth investors.
Listing	Listed on a recognised stock exchange. Available for on-market trading.	Not listed. Available only for OTC trades. Usually, unlisted companies put restrictions on transferability of their shares through their articles of association.

Characteristic	Listed Equity	Unlisted Equity
Liquidity	Highly liquid (subject to not being an infrequently traded share).	Illiquid, since it can only be traded bilaterally on OTC basis.
Counter-party risk in trading	No, since Clearing Corporation is the counterparty	Yes
Regulation	Highly regulated	Less regulated
Management Control	Depends on shareholding pattern	Usually with the family shareholders
Investment Valuation	Derived through market price for retail investments or last traded price	Determined through a valuation process.

2.2.2 Fixed income securities

Debt instruments, also called fixed income instruments, are contracts containing a promise to pay a stream of cashflows during the term of the contract to the investors. The debt contract can be transferable (a feature specified in the contract that permits its sale to another investor) or non-transferable, which prohibits sale to another party.

Generally, the promised cashflow of a debt instrument is a periodic payment, but the parties involved can negotiate almost any sort of cashflow arrangement. A debt contract also establishes the financial requirements and restrictions that the borrower must meet and the rights of the holder of the debt instruments if the borrower defaults.

Debt securities are issued by companies, municipalities, states and sovereign governments to raise money to finance a variety of projects and activities. Debt instruments can further be classified on the basis of issuer into government debt securities and corporate debt securities where the issuer is a non-government entity. Government securities form the largest component of debt market in India as well as the world. Further, fixed income securities can be classified on the basis of their maturities. Money market securities have maturities of one year or less than one year, whereas, capital market is a place for long term fund mobilisation. Since the investment horizon in capital market is longer, the uncertainty about the future cash flows go up. Investors require extra compensation for the same. It is referred as “term premium”.

2.2.3 Derivatives

Derivatives are financial instruments whose value depend upon or are derived from the value of other, more basic underlying variables. These are traded both in the OTC market and on exchanges. The exchange-traded derivatives in India are futures and options. Futures contracts are agreements between a buyer and seller to buy or sell the underlying asset at a predetermined price and quantity on a predetermined date. Options are contracts that give the holder of the option the right (but not the obligation) to buy or sell the underlying asset at a predetermined price and in a specified quantity at or before a predetermined date. There are two kinds of options: options that allow the holder the right to buy the underlying asset are known as 'call' options; Options that allow the holder the right to sell the underlying asset are known as 'put' options. The predetermined price at which the asset can be bought or sold by the option holder is known as the 'exercise' or 'strike' price. Both futures and option contracts are settled on a predetermined date known as 'expiry' date. Thus, derivatives have a short shelf life and as investments they are primarily meant for investors with a short investment horizon. Exchange-traded derivatives are now available for trading on the entire spectrum of assets encompassing equity, debt, currencies and commodities.

2.2.4 Money Market Instruments

Money market instruments are used for raising and investing funds for periods ranging from one day up to one year. The purpose of the money market is to enable institutions and companies to meet short-term funding needs by borrowing and lending from each other. Money market securities consist of repos/reverse repos, certificates of deposits, treasury bills, and commercial papers. All these securities are issued at a discount and redeemed at par, and are zero coupon in structure. The Reserve Bank of India regulates the money market segment.

2.3 Types of Alternative Investments

There are several avenues for creating alternative assets such as venture capital, private equity, hedge funds, real estate, precious metals, arts and antiques etc. These are briefly explained below.

2.3.1 Venture Capital/ Venture Debt

Venture capital (VC) investing is about direct investment in infant companies with businesses that are yet to grow or evolve completely. These businesses are also known as 'start-ups or

‘early stage’ businesses. AIF Regulations state that these are concerned with new products, new services, technology or intellectual property based activities or a new business model. These nascent ventures show high promise to grow into large businesses or start to demonstrate growth at a very high growth rate year on year. Since these businesses are small, they are susceptible to high mortality rate. Assessing their future potential is also a difficult and complex task. Venture capital investments are therefore considered highly risky and rank as such among alternative investments. The rationale of VC investments is to make higher returns based early investment in the business growth potential.

In order to give impetus to start-up financing in India, the Government of India under the Department for Promotion of Industry and Internal Trade (DPIIT) defines a start-up as a business that is not more than 10 years old and has not recorded a turnover of more than INR 100 crore in any financial year. Such companies have to be engaged in innovation, development or improvement of products, or a scalable business model with a high potential of employment/ wealth generation.

A part of the venture capital ecosystem also consists of venture debt which is a specialised form of lending to start-ups that have successfully raised institutional venture capital equity. Venture debt usually carries a higher rate of interest than normal commercial loans to incorporate the higher risk associated with start-ups. It is usually taken to meet the requirements of spikes in cash requirements of high growth start-ups without the need to dilute further equity. Therefore, it complements venture equity financing very effectively. It is usually paid back in about 2-3 years by financing the repayment with subsequent rounds of equity financing. Venture debt funds that specialise in providing such financing generate better returns from higher interest and fee earnings than conventional lenders.

2.3.2 Private Equity

The term ‘private equity’ (PE) has wider import and is a generic term used for direct investments in companies that are not listed on a stock exchange. In other words, it is equity capital raised by companies from external investors without accessing public equity markets. Therefore, venture capital is a type of private equity used for early stage businesses. But the term ‘private equity’ is predominantly used to denote investment in companies with established business model and track record (known as ‘later stage’ companies). Private equity also participates in more complex transactions involving control acquisitions (known as ‘buyout’) and Leveraged Buy Outs (LBOs) which comprise of doing buyouts with significant leverage. In such transactions, investors typically look to acquire controlling interests of either 51% or more of the share capital or voting rights of a target company. Conventionally, pure play private equity model revolves around providing growth capital to later stage unlisted companies by subscribing to their equity capital. The rationale of PE investment is

to achieve higher than market returns by investing in promising and growing unlisted companies and exiting at higher valuations in future based on their future performance.

The word 'equity' has a wider import in private equity parlance. The term 'private equity' includes equity, preference, debt or mezzanine capital depending upon the structures used in specific transactions. Mezzanine capital refers to funds that are provided in a hybrid structure involving the features of both debt and equity capital.

2.3.3 Hedge Funds

Hedge Funds are pooled investment vehicles, which make investments in financial assets, complex derivative contracts and currencies. The factors that differentiate hedge funds from other AIFs are as follows:

- (a) The objectives of Hedge Funds allow them to invest across different classes of assets (i.e. financial assets, currencies, complex derivatives),
- (b) Hedge Funds use complex investment strategies (such as arbitrage, carry trade etc.) for variable outcomes and complex risk patterns and
- (c) Hedge Funds take both long and short positions and use significant leverage at fund level.⁶

This breadth of investment platform given to hedge funds is what makes them speculative and highly susceptible to capital at risk. It is the ability of these funds to go both long and short in various markets that has given them the name '*hedge funds*'. SEBI defines a hedge fund as an "*Alternative Investment Fund which employs diverse or complex trading strategies and invests and trades in securities having diverse risks or complex products including listed and unlisted derivatives*".

2.3.4 Real Estate and Infrastructure

Alternative investment is also related to the real estate sector where investment can be made into property development companies or specific projects. While general investors acquire personal properties either for occupation or as long-term investment, alternative investors look for more sophisticated and risky investment avenues. These include investment in real estate funds that finance big ticket projects. Such investments entail

⁶ 'Leveraging at fund level' means that the fund entity will borrow from market sources in order to make investments as a part of its investment activity. The idea is to generate arbitrage return for the fund by using debt (which costs lesser) to make investment gains (which are meant to be higher). However, this strategy also increases overall investment risk as the fund is obligated to pay back the debt irrespective of investment gains or losses. Therefore, hedge funds are characteristic of higher risk taking as compared to other AIFs that do not leverage at fund level.

considerable market risk associated with the sector or illiquidity risk due to long gestation period. Some of these are also structured as real estate Private Equity (PE) funds that provide growth capital to companies engaged in the real estate sector or project specific SPVs. A recent addition to the real estate portfolio is Real estate Investment Trust (REITs) that offer the advantage of investing in the sector without physically holding real estate assets. REITs are securities that entitle the holders to underlying cash flow generated from rent yielding properties. Since REITs are liquid due to their listed status, they are sometimes considered either traditional assets or in the dual category.

Similar securities issued by entities managing large infrastructure assets with long term contracts that ensure steady and periodic returns (with predictable and lower level of risk taking on their cash flow) are known as Infrastructure Investment Trusts units (InvIT units). These are preferred by low risk-taking long-term investors such as pension funds and insurance companies. InvITs are also listed and tradable on the capital market making them akin to traditional assets.

2.3.5 Distressed Securities

Distressed securities are the securities of the companies that are in financial distress or near bankruptcy. Investors can make investments in the equity and debt securities of publicly traded companies. These may be available at huge discounts, however investments in them require higher skills and greater experience in business valuation than regular securities. These securities can be considered from the perspective of diversification of risk. These securities are also referred as 'fallen angels' and many types of funds and institutional investors are prohibited from holding these securities because of the high risk involved. It is a popular investment segment among hedge fund managers as they have deep experience in valuation and credit analysis.

2.3.6 Other investments

Art and paintings and rare collectibles are emerging as an attractive long-term investment opportunity. This category of investment has been generating moderate returns in the long term. It also has low correlation with financial investments such as equities and bonds. Hence, it provides good risk diversification benefit. However, these are big ticket investments. Also, art is not a standard investment product as each work is unique. The market for the same is unregulated. These investments do not provide any income and just like gold, capital appreciation is the only way of reward. In terms of liquidity, this category is relatively more illiquid. To make rewarding investment decisions, specialised knowledge in arts is more crucial than in traditional financial assets due to higher levels of information asymmetry and adverse selection problems. There are art and painting based investment funds. Investors can take exposure through these funds.

With the emergence of new generation technologies and ESG (Environment, Social and Governance) as **sunrise sectors** for investment themes, several alternative investors have started to position themselves for these sectors. AI (Artificial Intelligence) as a subset of Machine Learning, Virtual Reality and Artificial Reality, Green energy and renewables, sustainability and ecological conservation, social justice and empowerment are sunrise sectors around which AIF themes are being built for the future.

The institution of a specialised bankruptcy law in the form of the Insolvency and Bankruptcy Code 2016 as well as the maturity of the M&A and buyout space have brought in the emergence of **special situation funds** which can invest / lend in corporate resolutions, control acquisition of distressed companies, financing M&A deals and SPVs and other such structured financing deals.

The AIF space also accommodates the presence of **fund of funds (FoFs)** which are AIFs that do not invest directly in investee companies. Instead, they invest in other AIFs (a practice that is more common with hedge funds). Such funds may not have a specialised investment theme. Rather the investment is about risk diversification by investing in several thematic funds. FoFs choose to rely on the expertise of other AIFs and generate returns by investing in them. FoFs are also suitable for offshore AIFs that do not have a permanent establishment in India for pursuing active fund management.

2.4 Channels for making investments

Investors can invest in any of the investment opportunities discussed above directly or through intermediaries providing various managed portfolio solutions.

2.4.1 Direct investments

Direct investments are when investors buy the securities issued by companies and government bodies and commodities like gold and silver. Investors can buy gold or silver directly from the sellers or dealers. In case of financial securities, a few fee-based financial intermediaries aid investors buy or sell investments viz. brokers, depositories, advisors etc., for fees or commission.

2.4.1.1 Role of registered Investment Advisers

Investors can take the advice from SEBI Registered Investment Adviser (RIAs). As per SEBI Regulation relating to RIAs which came in the year 2013, only qualified professionals who are licensed by SEBI as Registered Investment Advisers (RIAs) can act as 'advisers'. These advisers are paid fees by the investors who hire them for investment advice. After this regulation, the distributors of financial products like mutual fund distributors, share brokers and insurance agents who would earlier act as investment advisers, can no longer claim the title. These advisers, like other fee-based professionals, are accountable to their investors. They are required to follow a strict code of conduct and offer advice in the investors' best interests. They are also required to disclose any conflict of interest. Advisers do basic risk profiling, assess the needs and requirements of the investors, understand their financial health and develop 'financial plans'. They help in inculcating a sense of discipline in investors. Thus, advisor can help investors create an optimum investment portfolio and help them in making rational investment decisions.

2.4.2. Investments through managed portfolios

Alternatively, investors can invest through investment vehicles which pool money from investors and invest in variety of securities and other investments on their behalf. In other words, investors make indirect investments. These investment vehicles are professionally managed. Through these managed portfolios they can avail the professional expertise at much lower costs.

The following are examples of managed portfolio solutions available to investors in India:

- Mutual Funds
- Collective Investment Schemes
- Portfolio Management Services
- Alternative Investment Funds
- Specialized Investment Funds

2.4.2.1 Mutual Funds

A mutual fund is a trust that pools the savings of a number of investors who share a common financial goal. Money collected through mutual fund is then invested in various investment opportunities such as shares, debentures and other securities. The income earned through these investments and the capital appreciation realized are shared by its unit holders in proportion to the number of units owned by them. Mutual fund is a pass-through intermediary in the true sense.

The following are the benefits of investing through mutual funds:

- Professional investment management

- Risk reduction through diversification
- Convenience
- Unit holders account administration and services
- Reduction in transaction costs
- Regulatory protection
- Product variety

However, mutual fund products are not 'get rich quick' investments. They are not risk-free investments. Mutual funds are strictly regulated by SEBI under Mutual Fund Regulation 1996.

2.4.2.2 Portfolio Management Services

A portfolio manager is a body corporate who advises or directs or undertakes on behalf of the investors the management or administration of a portfolio of securities. There are two types of portfolio management services available. The discretionary portfolio manager individually and independently manages the funds of each investor. The non-discretionary portfolio manager manages the funds in accordance with the directions of the investors.

The portfolio manager enters into an agreement in writing with the investor, clearly defining the relationship and setting out their mutual rights, liabilities and obligations relating to the management of funds or portfolio of securities.

Portfolio Management Services are regulated by SEBI under Portfolio Manager Regulations. The regulations provide that the portfolio manager shall charge fee as per the agreement with the client for rendering portfolio management services. Portfolio managers provide investment solutions unique to the needs of the investors.

2.4.2.3 Alternative Investment Funds

Alternative Investment Fund or AIF is a privately pooled investment vehicle which collects funds from sophisticated investors, for investing them in accordance with a defined investment policy for the benefit of its investors. The words 'privately pooled' denote that the fund is pooled from select investors and not from the general public at large. These private investors are institutions and high net worth individuals who understand the nuances of higher risk taking and complex investment arrangements.

2.4.2.4 Specialized Investment Funds⁷

SEBI in its recent amendment to SEBI (Mutual Funds) Regulations, has introduced a new product line under mutual funds known as Specialized Investment Fund (SIF). SIFs are sophisticated mutual funds where the minimum required investment amount is Rs. 10 lakhs from the investors across all investment strategies.

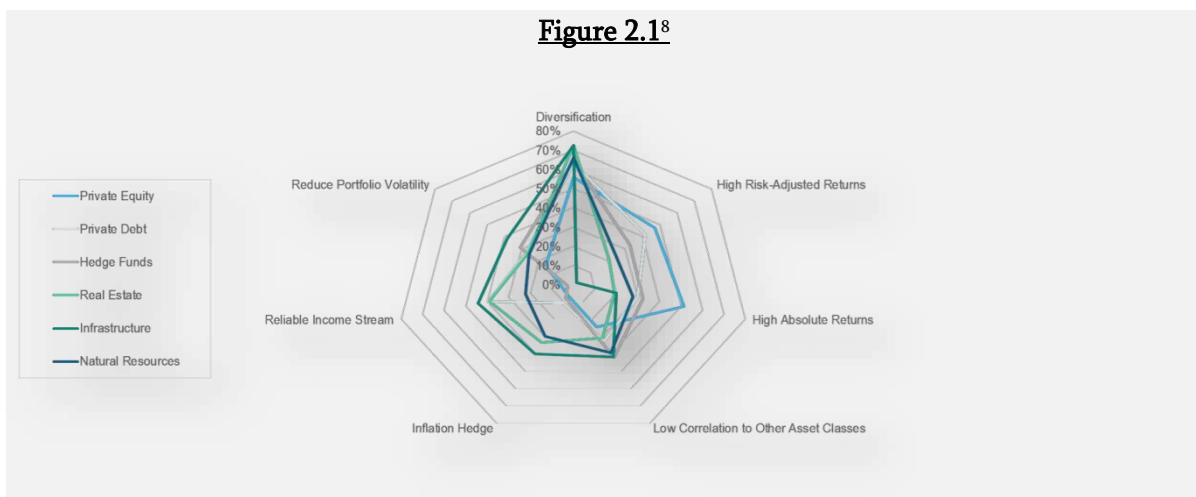
⁷Vide SEBI (Mutual Funds) (Third Amendment) Regulations, 2024 w.e.f. December 16, 2024.

2.5 Role of Alternative Investments in Portfolio Management

Portfolio management needs to be ever-evolving in order to meet improved return expectations of investors. However, this is easier said than done. In the 21st century new challenges have been emerging to generate business returns from established business models due to technological innovations, environmental concerns, regulatory challenges, economic volatility in several economies, geo-political issues and changing needs of markets and customers.

While there are new opportunities to be explored in the developed markets, emerging markets are the hot bed of growth and innovation especially in the emerging sectors of business. In order that investors generate superior returns, it is necessary to look beyond traditional investments. Institutional fund managers are aware of the need for new avenues to diversification of their portfolios. There are huge opportunities in handholding new ventures in sunrise industries and technologies as also in structured products emerging from these markets. Asset allocators in institutional investment classes should not miss out on improved diversification and stellar early or first-mover returns (i.e., high returns resulting from investing early into new asset classes).

The rationale for alternative investments is not just about returns. Investors are looking at alternative investments for other reasons as well. Figure 2.1 represents the position.



In the above exhibit, the nature of each type of AIF with regard to the given set of factors is explained. For e.g. private equity funds score better on the criteria of 'High Absolute Returns' and 'Diversification' but score poorly on 'Reliable Income Stream'. This is because, they invest in growth companies that usually provide good exit returns but do not declare

⁸Source: www.preqin.com [Extract from a presentation by Preqin dated July 7, 2019]

significant dividends. Similarly, infrastructure funds compare well on the parameters of 'Reliable Income Streams' as they predominantly invest in InvITS and operational projects that provide steady income streams. However, infrastructure projects rate poorly in terms of risk-adjusted returns. The following Table 2.3 captures the strengths and limitations of alternative investments.

Table 2.3: Comparative Assessment of Alternative Investments

BENEFITS	LIMITATIONS
Helps in risk diversification by moving beyond traditional investment avenues.	Complex fund structuring is required which makes it difficult for investors to comprehend.
Provides better risk-return trade-off by actively investing in high-growth opportunities and monitoring them.	Complex contractual terms and tedious documentations make it necessary for investors to constantly seek professional support.
Alpha return generation due to off-market investment strategies.	Less transparency as compared to traditional investments. Difficulty in assessment of underlying risks.
Provides growth capital to businesses and companies that may not be able to attract conventional sources of capital such as bank financing.	More complex contractual terms and return determination methodologies as compared to traditional investments.
Provides the services of fund managers who are experienced in generating customised investment opportunities to maximise returns.	Illiquidity is one of the main disadvantages as many of the investment opportunities have a long investment cycle.
Sometimes, there is scope for customisation in investment terms in a limited way as compared to a standardised investment template for all investors in a given fund or scheme.	Do not satisfy the requirement for regular income.

The challenge for an asset allocator in the 21st century is to consider alternative investments across markets and asset classes and to decide, as skilfully as possible, which new types of

assets to include in a portfolio and which to exclude. Without the inclusion of alternative investments, portfolio management cannot meet the challenge of generating consistent superior returns or the 'alpha' when economic challenges are limiting the returns from traditional investments. At the same time, asset managers have to be mindful of the limitations and risks of alternative investments in terms of untried sectors or technology, business risks, illiquidity risk, market risks, entrepreneurial limitations, contractual risks and economic factors that could limit the alpha generation from such investments. Both empirical analysis and economic reasoning have to be considered equally in making such portfolio diversification choices.

However, there are challenges ahead. High valuations in emerging markets, volatile capital markets across the world, anti-globalisation trends, geo-political risks emerging from trade wars and other factors, constant rate adjustments by central banks leading to higher interest rate volatility and of course, the increasing call from global economists about the next recession have dampened investor sentiment and increased uncertainty risk. The pace of technological change has become too fast to grasp and disruption trends are making it harder to forecast winners and losers in almost every industry, whether existing or emerging.

2.6 Alternative Investments – Antecedents and Growth

After the Industrial Revolution of 18th century, the size and scale of business operations (mostly manufacturing) required large financing and corporatisation. Though bank financing was the mainstay for business finance, venture capital made a beginning as a risk financing model in situations which banks perceived as risky or unworkable. Venture capital at this stage was not institutionalised but mostly confined to wealthy individuals. The early merchant banks of UK became the first institutional financiers which later on spread to other parts of Europe and USA.

In parallel, there was also a steady growth and organisation of investment fund pools centred on bank treasuries, endowment funds, pension funds and insurance companies. In the early days of investing, the traditional approach advocated safety over diversity due to which, till the 1920s, institutional investors invested in government securities, mortgages and preference capital. Slowly institutional investing became professionalised to meet the requirement to manage such large pools of investible funds. Around the 1940-50s, US witnessed its first batch of institutional venture funds run by professional venture capitalists that identified venture capital as the early-stage risk capital for small businesses. Beginning with the 1950s and 1960s, modern portfolio theory made considerable advances which established the mechanics and advantages of diversification advocating the principle that

risk from alternative investments can be diversified. While diversification of business risk was evident in corporate strategy, investment strategy for institutions began to be increasingly evaluated on a portfolio basis.

Portfolio assessment of investment risks revolutionised the basket of assets available for investment. Several investment options hitherto considered risky assets such as small cap and unlisted stocks, low quality listed and unlisted corporate bonds, high-yield debt, structured products and other alternate asset classes became common among institutional investors as a part of portfolio risk diversification strategy to maximise returns better than from traditional assets. Evaluated on a standalone basis, many of these alternative assets had insufficiently reliable income and were even subject to the risk of capital loss as well in some cases. But when held in a portfolio, these relatively high-risk investments could lower the total risk of the portfolio because of their ability to provide improved diversification.

In the 1980s, the flow of funds into this industry was enormous with more types of investors getting into financing young unlisted business companies. However, the industry had its share of setbacks during the late 1980s. The industry suffered again during the dotcom bust in 2001. However, the industry gathered its feet again and both venture capital and later stage private equity hit the high growth curve after 2004. The stage was also set for larger PE funds to enter the control acquisitions (buyout) market which is presently a large segment of the global private equity and M&A market.

In the post-2008 scenario, alternative investments went through a big leap as market opportunities in traditional investments became more difficult to satisfy investor requirements for differentiated returns. According to the Bain Private Equity Report, the period since 2014 was that of unprecedented success for the private equity industry.⁹ During that span, more money was raised, invested and distributed back to investors than in any other period in the industry's history. Alternative debt funds also grew substantially creating markets once again for high-yield debt and structured products such as real estate investment trusts and infrastructure investment trusts.

2.6.1 Venture Capital and Private Equity Funds: Global Market Overview

Venture capital and private equity industry forms the major part of the AIF ecosystem globally. The US has the largest private equity industry followed by Europe. Due to traditionally low interest rates and asset valuations in the stock market and real estate sectors, the alternative asset industry has been robust in both the continents. In the US, PE firms have diversified beyond their traditional focus on LBOs and control acquisitions. PE firms invest in a wider range of sectors, notably high technology, healthcare, real estate,

⁹ Global Private Equity Report 2019, Bain & Company

ESG, clean mobility and renewable energy. The European PE industry is quite large and diversified as well across sectors and investment themes. The larger funds deal with large cap companies but the industry has a mid and small segment as well with several venture capital funds that specialise in specific niches, such as growth-stage investing or technology-focused deals. AIF industry across the EU is regulated by the European Union's Alternative Investment Fund Managers Directive. PE markets across Latin America, Africa and the Middle East are quite modest, though the outlook remains very positive.

According to Preqin Research, the global AIF market was at USD 13 trillion in 2021 and is expected to grow to USD 23 trillion by 2026. According to another research by McKinsey¹⁰, the market size of private asset management was USD 11.7 trillion as of June 2022. After a buoyant phase till 2021, the year 2022 witnessed tailwinds emerging from correction in private asset valuations and a slowdown in funding deals (referred to as 'funding winter').

Across emerging markets India witnessed an exponential growth of the AIF industry (all 3 categories).

¹⁰Source: 2023 McKinsey Global Private Markets Review

Sample Questions: Chapter 2

1. _____ represent ownership in a company that entitles its holders to participate in its profits and the right to vote on the company's affairs.

- a) Bonds
- b) Commercial Papers
- c) **Equity Shares**
- d) All the above

2. Financial assets are generically classified into two broad categories _____.

- a) **Debt & Equity**
- b) Bonds and deposits
- c) Real estate & gold
- d) Equity & gold

3. In India, the Central Government issues _____.

- a) Treasury bills
- b) Dated securities
- c) **Both a & b**
- d) Certificate of deposits

4. Alternative investment is defined as a _____ that does not fall into one of the conventional investment categories.

- a) mutual fund
- b) **financial asset**
- c) personal property
- d) financial planning

5. The following is an example of alternative investment.

- a) Investment in AAA listed bond
- b) Investment in Government securities
- c) **Purchase of commercial real estate**
- d) Investment in Exchange traded futures

Section B: Understanding the AIF Ecosystem

CHAPTER 3: ALTERNATIVE INVESTMENT FUNDS IN INDIA AND ITS SUITABILITY

LEARNING OBJECTIVES:

After studying this chapter, you should know about:

- Evolution and growth of Alternative Investment Funds in India
- Types of Alternative Investment Funds
- Different categories of AIFs as per SEBI (AIF) Regulations, 2012
- Suitability of AIF products to different class of investors
- Current market status of AIFs in India

3.1 Evolution and Growth of AIFs in India and Factors enabling preference for Indian AIF market

Evolution of Venture Capital and Private Equity

The evolution of alternative investments in India can be traced to the Venture Capital Guidelines notified on 25th November, 1988 by the Government of India which initially provided a restricted scope for venture capital (VC) financing.

The scope for VC was broad-banded by SEBI in 1996 by notifying a new set of regulations for the VC industry called the SEBI (Venture Capital Fund) Regulations, 1996 which brought the entire spectrum of private capital investment in unlisted companies into the ambit of institutional investment. Subsequently, tax breaks were given to VCFs at fund level and the SEBI regulations were also revised following the recommendations of the K.B. Chandrasekhar Committee in 2000. In the growth phase that followed from 2003 with the emergence of a strong domestic capital market and the impressive growth of corporate India, many Venture Capital Fund and Private Equity Funds emerged mainly with off-shore capital. Domestic institutions such as ICICI, UTI etc. evolved into full-fledged private equity players.

From a business perspective, from 2001 onwards, Indian industry was on a consolidation drive in various sectors. This corporate growth initiative coupled with an investor friendly regime and good economic conditions led to a spurt in private equity activity in India. The first characteristic private equity transaction in India is arguably the USD 292 million investment made by Warburg Pincus in Bharti Televentures Ltd which also resulted in a successful exit strategy for the fund when Bharti was taken public with its IPO in 2002.

In the initial stages, though private equity was largely confined to the information technology sector, by the end of 2007, the sectoral bias was largely removed and private capital had got extended to several other sectors. In addition, the Indian market also saw the emergence of buyout transactions spearheaded by funds such as Blackstone, KKR, Actis

etc. which acquired controlling interest in both listed as well as closely held companies. The buyout of Flextronics Ltd by KKR in 2006 was a landmark deal.

In the aftermath of the Global Financial Crisis 2008, the industry was subdued till 2012 until growth started to pick up significantly from 2012 mostly due to the introduction of the SEBI (Alternative Investment Funds) Regulations. But the period between 2011 and 2019 can be termed as the consolidation and transformation phase during which some of the older funds exited and newer funds consolidated their presence. This phase also marked the transformation of a VC and PE industry into an AIF industry.

Trends Post 2012:

The significant trends post 2012 can be summarised as follows:

- The industry evolved from a predominantly venture capital and private equity industry into a full-fledged alternative investment industry spanning several alternative asset management funds and UHNIs / family offices. For e.g. Real estate sector and infrastructure sector are two examples in point.
- Global events such as Brexit and US-China trade war notwithstanding, private equity inflows and activity reached record levels in Asia Pacific region with India registering highest growth in 2017¹¹ and 2018¹².
- The significant emergence of domestic capital to support the AIF industry has been evident during this phase. The AIF industry caught the fancy of the ultra-rich billionaires of India. Several new fund houses and investment managers set up or launched new AIFs to cater to the very wealthy Indian investor community.
- Government reforms were introduced to provide tax incentives to start-ups. This has given the much needed boost to the Private Equity and Venture Capital markets and ensured continuous inflow of capital from international and domestic investors such as Sovereign Wealth Fund, Pension Funds, Foundations, Insurance Companies, Banks, Charitable Organizations, Family Offices and High Net Worth Individuals.
- The domestic AIF market grew by identifying new alternative investment opportunities such as pre-IPO financings, special situations such as stressed asset auctions under the Insolvency and Bankruptcy Code 2016, debt resolution refinancing with banks, M&A financings and co-investments, real estate debt financings, mezzanine funding, infrastructure debt and equity funds and so on.
- Rationalisation of Total Expense Ratio (TER) charged by equity-oriented Mutual Fund schemes, as per amendments made to SEBI (Mutual Funds) Regulations, have encouraged mutual fund managers to exit and launch their own vehicles as AIFs in India and make investments, with greater flexibility. As per the structure of AIFs,

¹¹ PWC Report – Reflections – Indian Private Equity in 2017 Page 2

¹² India Private Equity Report 2019 – Bain & Company

Managers of AIFs are flexible to charge Performance-based Fees, on the 'Additional Return' earned by the fund above the 'Reference Hurdle Rate'. This fee is paid in addition to the Management Fees charged at a fixed rate by the Manager, on a yearly basis.

- The emergence of e-commerce and digital technology start-ups with cutting edge solutions to myriad service delivery and frontier areas such as fintech, digital payments, artificial intelligence, Internet of Things, Machine Learning, Data Analytics, Cloud Computing etc. has provided a new world of opportunities for AIFs and has also been instrumental in bringing in enormous capital from off-shore funds and sovereign wealth funds as well.

3.2 Types of AIFs

The SEBI (Alternative Investment Funds) Regulations 2012 (AIF Regulations) that currently regulate such activity define the term 'Alternative Investment Fund' (AIF) as one which is primarily a privately pooled investment vehicle. However, since there are several types of investment funds in the market, the definition prescribes that only a '*privately pooled*' structure with funds pooled from India or abroad for a defined investment policy is to be considered as an AIF. *The words 'privately pooled' denote that the fund is pooled from select investors and not from the general public at large.* These private investors are sourced from categories such as institutions and HNIs who can understand the nuances of higher risk taking and complex investment arrangements. Nonetheless, the following categories are explicitly excluded from this definition:

- Any fund which is a mutual fund or a collective investment scheme as per SEBI regulations.
- Family trusts, ESOP or other such employee benefit trusts, holding companies, SPVs set up for securitisation or other such purposes.
- Funds set up under RBI regulations such as securitisation companies or under the purview of any other regulator.

It may be noted that the exclusions are either private funds of a company, business or a family or those that are regulated by other regulators such as RBI or IRDAI or PFRDA or IFSCA.

Alternative Investment Funds (AIFs) can be of different types based on their investment strategy and types of assets under management. Under the SEBI (AIF) Regulations, 2012, a Sponsor or trustee (if AIF is in trust form) can register as Category I, Category II or Category III AIFs.

3.2.1 Category I AIFs

Category I AIF is an AIF that invests in start-ups, early-stage ventures, social ventures, SMEs, infrastructure or other sectors or areas which the government or regulators consider as socially or economically desirable and shall include Venture Capital Funds, SME Funds, Social Impact Funds, Infrastructure Funds, Special Situation Funds and such other AIFs as may be specified under the Regulations from time to time. Other funds that are considered economically beneficial and are provided special incentives by the government or any regulator are also considered as part of this Category. Corporate Debt Market Development Fund (CDMDF) is also classified under Category I AIF as the fund is set-up with the broader economic objective of development of corporate bond market, inter-alia, to act as a Backstop facility during times of market stress.¹³

- **Venture Capital Fund**

Venture Capital Fund (VCF) means “an AIF which invests primarily in unlisted securities of start-ups, emerging or early-stage venture capital undertakings mainly involved in new products, new services, technology or intellectual property right based activities or a new business model and shall include an angel fund”.

“Start-up” means a private limited company or a limited liability partnership which fulfils the criteria for start-up as specified by the Department of Promotion of Industry and Internal Trade, Ministry of Commerce and Industry, Government of India, vide notification no. G.S.R.127(E) dated February 19, 2019 or such other policy of the Central Government issued in this regard from time to time.¹⁴ “Venture capital undertaking” refers to domestic company which is not listed on a recognised stock exchange at the time of making investment.

Venture capital can be termed as the first stage of institutional financing in an early-stage company or start-up, generally after the angel funds are successfully raised by such company or start-up. It is mostly applicable to asset light businesses that are intensive in technology, intellectual property or digital media applications.

- **Angel Fund**

Angel Fund means “a sub-category of Venture Capital Fund that raises funds from angel investors and invests in accordance with the SEBI (AIF) Regulations”. Angel Investor is any person who proposes to invest in an angel fund and satisfies one of the following conditions, namely:

- (a) an individual investor who has Net Tangible Assets of at least INR 2 crore, excluding value of his principal residence, and who
 - i. has early-stage investment experience (i.e. prior experience in investing in start-up/ emerging/ early-stage ventures), or

¹³Vide SEBI Circular No.: SEBI/HO/IMD/PoD2/P/CIR/2024/174 dated December 13, 2024.

¹⁴ Inserted by the SEBI (Alternative Investment Funds) (Second Amendment) Regulations, 2021 w.e.f. May 5, 2021

- ii. has experience as a serial entrepreneur (i.e. a person who has promoted/co-promoted more than one start-up venture), or
- iii. is a senior management professional with at least 10 years of experience,

(b) a body corporate with a net worth of at least INR 10 crore

(c) a registered AIF under SEBI (AIF) Regulations or a venture capital fund registered under the erstwhile SEBI (Venture Capital Funds) Regulations 1996.

- **Infrastructure Fund**

Infrastructure Fund means “an AIF which invests primarily in unlisted securities or partnership interest or listed debt or securitised debt instruments of investee companies or special purpose vehicles engaged in or formed for the purpose of operating, developing or holding infrastructure projects”. Infrastructure debt or equity financing through AIFs is of recent phenomenon in India. Sovereign Wealth Funds, Multi-lateral Funds and Thematic AIFs are the key investors in this space, due to its high illiquidity, long gestation risk in project implementation and long amortisation of the debt to infrastructure projects.

- **SME Fund**

Small and Medium Enterprise (SME) Fund means “an AIF which invests primarily in unlisted securities of investee companies which are SMEs or securities of those SMEs which are listed or proposed to be listed on a SME exchange or SME segment of an exchange”. In this context, SME means a Small and Medium Enterprise and shall have the same meaning as assigned to it under the Micro, Small and Medium Enterprises Development Act 2006, as amended from time to time. Both BSE and NSE runs a separate segment for SME companies to list and trade. The eligibility criteria and compliances for the said exchange are more relaxed than the main board listing criteria.

- **Social Impact Fund¹⁵**

Social Impact Fund means “an AIF which invests primarily in securities or units or partnership interest of social ventures or securities of social enterprises and which satisfies the social performance norms laid down by the fund”.

‘Social Ventures’ are formed with the purpose of promoting social welfare, solving social problems, or providing social benefits. These may include:

- Public Charitable Trusts registered with the Charity Commissioner
- Societies registered for charitable purposes or for promotion of science, literature, or fine arts
- Section 8 company, registered as per the provisions of the Companies Act, 2013

¹⁵ Inserted by SEBI (AIF) (Third Amendment) Regulations, 2022 w.e.f. July 25, 2022.

- Micro-finance Institutions

- **Special Situations Fund¹⁶**

Special Situations Fund (SSF) has been included as a sub-category in Category I AIFs which are distressed debt funds now specifically defined by SEBI. SSFs can acquire debt / equity by participating in debt resolutions under the IBC 2016. They can also finance companies in default to banks and NBFCs for a period of not less than 90 days, acquire stressed loans and security receipts issued by asset reconstruction companies.

- **Corporate Debt Market Development Fund¹⁷**

Corporate Debt Market Development Fund is a close-ended AIF formed as a trust and with a 15-year tenure. Units of a Corporate Debt Market Development Fund are issued to Asset Management Companies. The purpose of such fund is to purchase corporate debt securities from debt-oriented mutual fund schemes during periods of market dislocation as may be decided by SEBI. Such debt-oriented mutual fund schemes must ensure that:

- Corporate Debt securities shall be listed and have an investment grade rating.
- Residual maturity of such securities shall not exceed five years on the date of purchase.
- Such securities have no material possibility of default or adverse credit news or views.

During such periods when there is no market dislocation, the fund will invest in liquid and low-risk debt instruments, in a manner specified by SEBI.

3.2.2 Category II AIFs

Category II AIF is an AIF that does not fall in Category I and Category III and which does not undertake leverage or borrowing other than as permitted in the Regulations. For this purpose, AIFs such as Private Equity Funds or Debt Funds, for which no specific incentives or concessions are given by the government or any other regulator, are included under this Category.

- **Private Equity Fund**

Private Equity Fund means “an AIF which invests primarily in equity or equity linked instruments or partnership interests of investee companies according to the stated objective of the fund”.¹⁸ It may be understood that private equity fund is primarily an equity-based

¹⁶SEBI (AIF) Amendment Regulations 2022 w.e.f January 24, 2022.

¹⁷ SEBI (Alternative Investment Funds) (Second Amendment) Regulations, 2023 w.e.f. June 15, 2023.

¹⁸Equity linked instruments include instruments convertible into equity shares or share warrants, preference shares, debentures compulsorily or optionally convertible into equity.

investment fund but unlike venture capital funds which are focussed on early stage investments, private equity funds are mostly involved in later stage financing in business entities that have established a business model and need to be scaled up for further growth.

- **Debt Fund**

Debt Fund means “an AIF which invests primarily in debt securities of listed or unlisted investee companies or in securitized debt instruments as per the stated objectives of the Fund.”¹⁹

Many types of debt that are private are considered to be alternative investments because of their illiquidity and often because they are not commonly held by traditional investors. Even listed companies issue debt securities such as non-convertible debentures (NCDs) and bonds through private placement that are not available in the traditional investment route.

Some of the venture financing funds also term themselves as ‘venture debt funds’ since they finance growth-stage venture capital undertakings through mezzanine financing, i.e. debt financing with an equity upside, like warrants attached to the debt. Pure venture debt funds are also prevalent that provide debt finance at a higher than market rate for high growth start-ups which are already venture equity funded.

Some private debt funds also finance sub-ordinate debt, in the form of ‘leveraged loans’ which is used in funding companies with high amount of senior debt on their balance sheet.

3.2.3 Category III AIFs

Category III AIF is an AIF that employs diverse or complex trading strategies and may employ leverage, including through investment in listed or unlisted derivatives. AIFs such as Hedge Funds or funds which trade with a view to make short-term returns or such other funds which are open-ended and for which no specific incentives or concessions are given by the government or any other regulator are included under this Category.

- **Hedge Fund**

Hedge Fund means “an AIF which employs diverse or complex trading strategies and invests and trades in securities having diverse risks or complex products including listed and unlisted derivatives”.

3.3 Comparison of Categories

It may be observed from the above definitions that under the SEBI (AIF) Regulations, AIFs that are economically important or socially impactful may enjoy greater benefits, under

¹⁹Inserted by the SEBI (Alternative Investment Funds) (Fourth Amendment) Regulations, 2018 w.e.f. August 13, 2021.

Category I AIFs. Angel Funds, Venture Capital Funds, SME Funds, Infrastructure Funds, Special Situations Funds and Social Impact Funds, that are considered important for employment generation, qualify under Category I AIFs. Other AIFs that invest in unlisted securities, such as Debt Funds, Private Equity Funds and Pre-IPO Funds fall under Category II AIFs. Those AIFs that deploy complex trading strategies in secondary listed markets, derivatives and or may also use leverage at fund level such as Hedge Funds qualify as Category III AIFs.

Being early-stage investors, Venture Capital Funds are allowed to invest primarily in unlisted securities i.e. equity, debt, preference capital or other convertible securities, of start-ups, emerging venture capital undertaking or early-stage companies. Therefore, the definition uses the word 'securities' to provide latitude to structure the investments appropriately. However, according to the definition of Private Equity Funds, these AIFs are required to invest primarily in equity or equity linked instruments or partnership interests of investee companies. This is because being later-stage investors, Private Equity Funds are in a better position to take equity risks in investee companies. Similarly, funds structured purely as Private Debt funds also qualify under Category II AIFs. Table 3.1 compares and contrasts between the categories of AIFs.

Table 3.1: AIF Comparison

Parameters	Category I AIF	Category II AIF	Category III AIF
Definition	Invests in start-ups, early-stage ventures, social ventures, SMEs, infrastructure or other sectors as may be specified.	All AIFs that do not classify under Category I AIF or Category III AIF.	Employs diverse or complex trading strategies and may employ leverage including through investment in listed or unlisted derivatives.
Scope	The sectors should be economically or socially desirable. Primarily the focus is on early-stage start-ups and unlisted ventures.	These funds that seek later stage investment opportunities do not use any leverage at fund level or indulge in complex trading operations.	These funds explore opportunities in primary and secondary markets through all types of securities including derivatives.
Risk strategy	Since early-stage ventures are subject to high mortality risk,	Generally, less risky than Category III AIF. Primarily seek returns from value	Complex risk-taking strategies including trading with leverage at

Parameters	Category I AIF	Category II AIF	Category III AIF
	these funds assume higher risks seeking higher return. But risk mitigation strategy is to invest in smaller tranches. Investors in this category have to invest a minimum of INR 1 crore (INR 25 lakh in angel funds). Generally, (subject to additional requirements for each sub-category), the AIF in this category has to invest primarily in unlisted companies or units of other Cat I AIFs. The maximum investment in a particular investee company cannot exceed 25% of the investible funds of the AIF scheme. Angel funds need to invest a minimum of INR 25 lakh and not more than INR 10 crore in a particular investee company.	creation and unlocking value by investing in later stage companies. Investment should be primarily in unlisted investee companies or units of other AIFs. The maximum investment in a particular investee company cannot exceed 25% of the investible funds of the AIF scheme.	fund level. Investment can be both in unlisted and listed companies as well as in other exchange traded securities, structured products and derivatives. The maximum investment in a particular investee company cannot exceed 10% of the investible funds of the AIF scheme.

3.4 Suitability of AIF products to Investors

India has seen tremendous economic growth post-liberalisation economic era, more particularly in the specific growth phases that followed. The economic prosperity of the entrepreneurial class and corporate executives created several high-net worth investors and family offices. Several NRIs also favour investing in Indian market and alternative investment products are an ideal asset class for being positioned for such investors. After SEBI allowed non-resident non-institutional investors to tap the Indian market as FPIs, it provided additional class of investors to invest in AIFs with India investment focus. India's economic prosperity has been underpinned by the increasing tribe of billion dollar ultra-high net worth investors (UHNI).

3.4.1 Suitability of Category I and II AIFs

The regulatory impetus to the AIF industry's growth has been provided with the introduction of the AIF Regulations by SEBI in 2012. They provided the necessary framework which made alternative investments space regulated for the participants. The Government of India also provided necessary support with the announcement that a 'fund of funds' of INR 10,000 crore for start-ups was established under the Department for Promotion of Industry and Internal Trade (DPIIT) which shall be managed by SIDBI under Category I and II AIFs. The fund would invest in SEBI registered AIFs which, in turn, would invest in start-ups. Thus, this fund would act as an enabler to attract private capital in the form of equity, quasi-equity, soft loans and other risk capital for start-ups. The Government of India also set up the National Infrastructure Investment Fund (NIIF) in 2015 as a Category II AIF to invest in infrastructure and strategic assets.

On the supply side too, the emergence of the start-up phase brought in several value creators in services and technology enabled business models. With increased focus on clean technologies and renewables, there are immense opportunities for companies to be set up in these spaces. The realty sector thrives in India primarily due to urban migration which drives the demand for more investments in both retail and commercial urban realty. The infrastructure space provides vast opportunities for debt and equity though it has some sectoral issues. With improved ease of doing business and policy facilitation by the government, the scope for alternative assets has only increased over time. The strong growth of the primary capital market with several blockbuster IPOs and new age businesses getting listed has increased the scope for favourable private equity exits resulting in further impetus to the private equity industry in particular.

The introduction of the Insolvency and Bankruptcy Code 2016 created a new space for special situation funds to step in looking for suitable opportunities in distressed asset sector pertaining to old economy companies. In addition, with improved governance regulations and management practices, the MSME sector which is a significant contributor to the growth story has immense potential to cater to the alternative asset class of investors. In view of

these developments, the AIF sector is most suitably positioned for investors and investee companies in India in the coming years

From an external perspective, the lack of growth in developed economies coupled with quantitative easing by the central banks over the past decade has created a situation of excess capital generation in these countries. This excess capital found its way into emerging high growth markets wherein India stands next only to China as a preferred investment destination. India's large economic potential and favourable investment climate make it a necessary part of the bucket list of global alternative investment funds.

Summary of Product Suitability under Category I and II AIFs

Investor Profile	Category I	Category II
HNIs / Early-stage technology investors, corporate venture capitalists, serial entrepreneurs, former corporate business executives and other such private capitalists looking for high risk alternative returns by financing primary capital to emerging business / high impact / social enterprises.	Seed and angel stage funding in start-ups, venture capital funds looking to invest in Series A institutional round financing in high potential companies, bootstrapped start-ups, family owned medium and small enterprises that have demonstrated a track record market share growth and profitability, social enterprises and high impact investments.	
HNIs / UHNIs /Family offices, Sovereign Wealth Funds, Fund of Funds, pension, Insurance/ endowment funds, and other such long-term pools of capital looking for medium to long term alternative returns from business entities.		Private equity funds investing in high growth potential companies seeking Series C and beyond equity financing, debt funds investing in high growth sectors like real estate, stable cash flow sectors like infrastructure and securitised/ structured debt products and special situation fund products
Investors profile based on ticket size of contributions	Those seeking to invest lesser amounts of capital in alternative investments as compared to larger	Those with deeper financial capability. Category II products such as buyout funds

Investor Profile	Category I	Category II
	exposures in other category AIFs.	are meant for very large institutional and UHNI investors.
Holding capacity without liquidity in unit capital	Category I is meant for early investors whose holding capacity is long.	Suitable for investors with medium to long-term holding capacity.
Risk taking mandate	High	Medium to High
Potential Financial Risk (Loss of Capital) bearing capacity	High	Medium to High
Capacity for illiquidity of the underlying investments by the AIF	High	High
Return expectations	High	Medium to High

Investors, before investing, should particularly read the Private Placement Memorandum (PPM) and look at some of the crucial clauses therein, to get detailed insights about the Fund, such as:

- “Investment Objective and Strategy” section elaborates on the targeted securities, investment style, sectors, geographic focus, and such other factors
- “Term of the Fund/Scheme” section states the fund structure, term of the fund/scheme, whether open or closed fund, final closing date and applicable extension periods.
- “Manager” section states the prior experience of the Fund Manager(s) responsible to take investment decisions for the Fund.
- “Redemption” section states the period during which investors can redeem their money back from the Fund. This section also provides information about the lock-in period and the redemption fees, or exit load to be paid by investors in case of early redemptions.

Illustrations – Let us consider investor suitability across Category I and II of AIF products.

1. An investor wishes to make investments in AIF products with a long-term time horizon but wishes to have relatively smaller ticket sizes and risk spread across potentially high growth smaller investee companies. The risk-taking ability is medium to high as the investor is seeking significant alpha returns. In this case, Category I AIF products such as Angel funds and to some extent, VC funds are appropriate as the risk-return profile, time horizon and ticket size of investments are appropriately matched. However, one has to caution the investor that Category I AIFs are close ended and therefore liquidity would not be available during the investment period.

2. An investor wishes to make investments in AIF products with a medium to long term time horizon and is considering growth oriented unlisted companies that have potential to go public or get acquired. The investor has risk appetite and deeper pockets for bigger investments but is looking for risk diversification in companies whose business plans and governance mechanisms are already validated by institutional investors. This investor profile fits very well with Category II private equity funds which specialise in larger deals in validated companies. However, the same caveat as in the earlier case above applies here as well and the investor needs to be cautioned on illiquidity during the investment period.

3.4.2 Asset allocation for HNIs and Institutional investors through AIFs

HNI investors and Institutional Investors diversify their portfolio to mitigate concentration risk on investing in only one asset class. Alternative investments serve as a good diversification option for HNI investors and Institutional Investors, looking to improve their target return.

²⁰**Example – 1** Let us consider an example of portfolio allocation purely in Category I AIFs

Particulars	Allocation
Seed Stage:	
Emerging Technologies such as AI / Robotics	20%
Advancement in Existing technologies such as SaaS, Cloud computing	10%
Venture Capital Series A/B	
Technology focussed funds	20%
Sector agnostic AIFs	30%
Venture Debt Funds	20%
Total	100%

²⁰ These examples are for illustrative purposes only. In actual practice, investors need to seek additional details of investment strategies of an AIF apart from the disclosures in the PPM. Actual diversification pattern may vary depending upon the underlying investments of the AIF.

In the above example a total allocation of 50% is towards technology focussed funds while the other 50% is distributed between all sectors and venture debt. This way, an investor may look at higher allocation to emerging technological companies while also benefitting from other sectors with a mix of pure equity and hybrid quasi-equity or sub-ordinated debt structures.

Example 2 – Let us now consider a similar allocation in purely Category II AIFs

Particulars	Allocation
Series C:	
Emerging Technologies / IT focussed AIFs	25%
Non-IT Sectors /Sector agnostic	35%
Pre-IPO / Others:	
Pre-IPO Placements	15%
PIPEs / Listed Stock	15%
M&A / Co-investment / Others	10%
Total	100%

In the above example, the investor is distributing exposure predominantly to later stage unlisted space while also keeping a reasonable allocation towards market opportunities such as pre-IPOs and M&A. Herein the technology focus is more broadly shared with non-technology sectors as well since there may be considerable growth companies available in later stage investing in non-technology spaces as well including industrials, FMCG, infrastructure, BFSI and so on. Hence keeping a good overall allocation of 75% towards a wider distribution of AIF opportunities is a good way of allocating towards growth opportunities as well as in distributing risk.

Though the above examples provide a justification for the illustrated risk allocation, it may not apply in every case and therefore diversification across AIFs may be required at investor level based on their profile.

3.5 Current AIF Market in India

AIF market in India has grown manifold post introduction of SEBI (AIF) Regulations in 2012. As on December 31, 2024, 1465 AIFs were registered with SEBI. Starting with just 21 funds in 2012, the industry has seen a high growth in terms of number of registered AIFs. Capital commitments raised by all registered AIFs (across categories) have surpassed INR 12.43 lakh crores as on September 30, 2023.²¹

3.6 Role of AIFs in Portfolio Diversification

AIF assets play an important role in risk diversification as well as possibility for upside alpha returns through portfolio diversification. Asset allocation with appropriate weightage for risk appetite is an integral element in portfolio management.

Even though, market investments are managed actively by portfolio managers and mutual fund managers, the added element of off-market investing in alternative assets offers return prospects and portfolio diversification opportunities for the risk-taking investors. Therefore, for HNIs, adding a component of AIF assets in the overall portfolio is a desirable strategy. AIF assets such as high growth unlisted equity and debt, real estate and infrastructure, special situation products such as distress and structured debt are opportunities that are not available in on-market investing. Diversifying further into Category III assets such as derivative products provides further impetus to such risk-taking strategy. Lastly, portfolio allocation by investing across Category I, II and III AIFs can bring in a wide portfolio diversification for all levels of risk-taking investors.

3.7 AIF as a Risk Management Tool

AIFs should be able to identify the material risks for the fund and report to their investors at predefined intervals. Material risks include:

- concentration risk
- foreign exchange risk
- leverage risk
- realization risk
- strategy risk
- reputation risk
- extra-financial risks, including ESG risk

Risk-averse investors will seek to minimize risk for a given return. Risk-taking investors will seek to maximise their return at a given risk level. In order to achieve the risk-return

²¹<https://www.sebi.gov.in/statistics/1392982252002.html>

objective of the Fund, it is imperative for the investment manager to identify the “source of return” for the Fund.

Identification of the source of return for the Manager is complementary to risk analysis and can provide important information on the following:

- **Sources of “alpha”** - Factors leading to outperformance by the Fund
- **Quantification of “beta”** - Sensitivity of the portfolio to market risk factors

Identification of sources of income and return attribution can impact future investment decisions, as the investment manager can analyse asset classes which result in outperformance or underperformance of the Fund. Hence, return attribution can add value to portfolio construction, future alpha generation, and portfolio beta management.

3.7.1. Alpha Management

‘Alpha’ is often meant to denote excess return as compared to market returns emerging from assuming systematic risk. Alpha has two connotations –

- 1) Alpha is the excess return expected from assuming ‘unsystematic risk’ which is associated with investing in alternative investments that may differ from traditional investments due to illiquidity, lower credit quality or other distinguishing factors. Under this connotation, alpha represents the difference between the observed return of an asset and the observed return of its market benchmark or other comparable performance measure, after adjusting for risk differences between the asset and the benchmark.
- 2) Under the second connotation, alpha represents an expected superior profit due to the use of skill of the fund manager in the selection and allocation of investments. In other words, let’s say that a portfolio is invested in index stocks. It will have a beta or systematic risk that is associated with the index and the returns would be equal to market returns. However, if the investments are picked carefully using investment strategies and the portfolio makes more than the market returns, the excess returns or the ‘alpha’ is attributable to the superior skill of the fund manager. This type of risk taking is referred sometimes as ‘alternative beta’ according to some schools of thought.

Alternative investments are all about generating the alpha return for taking unsystematic risks on assets as well as from superior fund management skills. Active management of fund portfolio is an important mechanism to generate alpha. Through active management of the portfolio, the investment manager attempts to outperform its benchmark by accurately identifying mispriced securities. With the development of technology, AIF managers are

using financial algorithms and machine learning techniques to identify mispriced securities and execute trades for the fund. However, there is a risk in making investment decisions, through active management, as the security prices can be impacted by broad-based market factors, such as, fear of a widespread disease in the country can affect the economy and even impact the growth of fundamentally strong companies. Therefore, investment managers should aim at diversifying the fund portfolio, by actively investing across multiple asset classes, geographies, industries and sectors.

For example, if a private equity has a track record to offer an alpha of 3%–5% over benchmark returns from the capital market, it means that due to the active fund management skills being deployed, the fund is expected to consistently outperform competitively priced assets of similar risk by an average of 3%–5% per year.

3.7.2 Beta Management

“Beta” measures systematic risk which is the change in the returns earned by the fund portfolio, on account of a change in the returns on a broad-based index. Higher the Beta for the fund portfolio, the more volatile is the fund portfolio as compared to the market return.

AIFs can be used by an Institutional Investor, for Alpha Generation as well as Beta Management.

Sample Questions: Chapter 3

1. An AIF that seeks to invest in unlisted securities of later stage companies belongs to which category?
 - a. Category I
 - b. Category II**
 - c. Category III

2. A fund that provides both equity and quasi-equity debt financing to early-stage companies would classify as which one of the following?
 - a. Venture capital fund**
 - b. Unsecured bond fund
 - c. NBFC fund
 - d. Investment Fund

3. An angel fund is a sub-category of a _____ fund.
 - a. private equity
 - b. mutual
 - c. collective investment
 - d. venture capital**

4. An investment pool that does not fall under any of the specified categories in the SEBI (AIF) Regulations 2012 is called a collective investment fund. State whether True or False.
 - a. True**
 - b. False

5. AIFs investing in start-up companies enable funding their working capital requirements. State whether True or False.
 - a. True**
 - b. False

CHAPTER 4: ALTERNATIVE INVESTMENT FUND ECOSYSTEM

LEARNING OBJECTIVES:

After studying this chapter, you should know about:

- Investments and characteristics of funds
- AIF ecosystem (Investors/ Sponsors/ Trustees/ Managers)
- Concepts prevalent in AIF industry
 - Capital commitment and Sponsor Commitment
 - Drawdown, Capital invested, First close and Final close
 - Fees and Expenses (Exit load/ Management fees/ Setup cost/ Operational expenses/ Hurdle rate/ High watermark)
 - Additional returns and Distributions
 - Due diligence and ESG

4.1 Concepts prevalent in the AIF industry

The AIF industry is nurtured by the private capital ecosystem that consists of primarily (a) the investors, looking out for alternative investment opportunities, (b) the alternative investment managers, having the expertise to identify, invest, manage and harvest the returns for investors, (c) the sponsors, who initiate and float the AIFs (more often the managers themselves) and (d) the external service providers who facilitate and make up the ecosystem. With the advent of an organised AIF industry and introduction of the SEBI (Alternative Investment Funds) Regulations, 2012, AIFs have witnessed significant growth after 2012 and many of these constituents of the private capital ecosystem are taking shape rapidly.

4.1.1 AIF Ecosystem

4.1.1.1 Investors/ Contributors

In the global markets, the following entities are some of the key investors in the AIF industry:

Foundations and Endowments: A Foundation is a not-for-profit organisation that donates funds and provides support to other organisations, for charitable purposes. An Endowment is an investment fund established by an individual or institution, such as a university, hospital, or foundation, to be used for pre-defined purposes, with a principal protection objective. Foundations and Endowments have long-term horizons and large corpuses, which

enable them to invest over longer gestation periods and manage the risk of illiquidity. They need to invest these with an objective to continue to be able to meet the foundation or endowment objective or philanthropic objectives.

Insurance Companies and Pension Funds: Investments from both private and public sector pension funds have been a significant catalyst in the growth of AIFs, globally. Insurance companies are ideally positioned with large, long-term, corpuses to become AIF investors.

In India, Insurance Companies and Pension Funds have regulatory caps on their asset exposures in alternative investments in the unlisted space in particular. Since these funds form the largest pool of domestic capital in India, their role is crucial in the development of AIF industry in India.

Sovereign Wealth Funds (SWF): In recent times, due to large trade surpluses generated by oil trade and global commerce, Sovereign Wealth Funds were started by several countries such as members of the OPEC, China, Japan, Singapore, UAE and Malaysia. These SWFs allocate funds in various sectors of the market, through the AIF route. Indian AIF Markets have witnessed a large influx of capital from Sovereign Wealth Funds, in listed equities, start-ups, infrastructure development and in the AIF market.

Family Offices and High Net-worth Individual (HNI) Investors: In the years following 2012, Indian AIF industry is being led by HNI accounts under Private Banking Managers and investment advisors, family offices, corporate investors, domestic bank promoted AIF funds and offshore investors. Family Office consultants have played a vital role in deploying funds to the AIF Industry, as a diversification tool. HNI Investors have shown keen interest in long-term, high-risk investments, apart from the traditional investments in real estate, gold and equities.

Fund of Funds (FoF): A Fund of Funds is a pooled investment vehicle, which invests in other AIFs in the industry, with the purpose of achieving greater diversification across different investment strategies. Separately Managed Accounts (SMA) are a carve-out, from the fund structure. While Indian Fund of Funds are still at their infancy stages, global markets have witnessed a significant growth in the Fund of Funds AUM.

In the Indian market, institutional activity in private capital generation for the AIF industry has been subject to both regulatory and market requirements. Indian AIFs are poised to grow exponentially, with expectations of large capital pools from foreign portfolio investors, domestic institutional investors and ultra-high net worth individuals.

Under the AIF Regulations, Indian, foreign and non-resident Indian (NRI) investors can be contributories to the corpus of an AIF.²²²³ However, the minimum investment requirement of each investor is INR 1 crore. The minimum corpus in each scheme shall be INR 20 crore and the maximum number of investors in a single scheme shall not exceed 1000. Moreover, keeping in view the character of an AIF, they are allowed to raise their corpus from investors only through private placement. SEBI had introduced the concept of Accredited Investors (AI) in order to provide flexibility to high net-worth investors and institutional investors when investing in large value funds under AIFs. The AIs may avail flexibility in minimum investment amount and concessions from specific regulatory requirements applicable to investment products, subject to specific conditions. The concept is discussed in detail in a later chapter.

Investors under the AIF regulations are called 'unit holders or contributors' or 'partners' or 'shareholders' depending upon the structure adopted for the AIF (trust, LLP or a company). In case of AIF trust, the corpus is represented by unit capital. In the case of a company, it is represented by share capital; and in the case of a LLP, it is represented as limited liability partnership interest. The investment corpus of the AIF trust is known as the 'unit capital'. Unit capital is defined as the beneficial interest of an investor in the AIF or the respective scheme. Unit holder gets proportionate beneficial interest in the corpus based on the number of units held. The economic benefit of the unit will be denoted by the growth in the unit value represented by its net asset value (NAV) that is disclosed by the AIF periodically.

4.1.1.2 Sponsors

Sponsor means any person or entity that is responsible for the formation and registration of the AIFs with SEBI, and includes promoter in case of a company and designated partner in case of a limited liability partnership. After seeking registration of AIF, the sponsor invests in the capital of the company or the partnership. In case the AIF is set up as a trust, the sponsor would contribute to the capital of the investment management company.

The sponsors or designated partners, as the case may be, shall perform the critical functions of sponsoring the fund, defining the theme, constituting the fund in the appropriate

²²Foreign investors are governed by the provisions of FEMA. All resident Indian investors (both institutional and non-institutional) can invest in AIFs from their domestic sources. However, domestic institutional investors (DIIs) such as banks, insurance companies and pension funds are further governed by their respective regulations on their eligibility and quantum of investment.

²³Corpus means the total amount of funds committed by investors to the Alternative Investment Fund by way of a written contract or any such document as on a particular date.

structure, registration with SEBI and formation of the initial and subsequent corpuses from time to time. Sponsor can also be the manager of AIFs.

The sponsor should satisfy the requirements of 'fit and proper person' based on the criteria specified in Schedule II of the SEBI (Intermediaries) Regulations, 2008. Any change in the sponsor or designated partner shall be informed to SEBI and where there is a change in control of the AIF, prior approval from SEBI is required to be taken by the AIF. Sponsors can be any person or persons including institutions or companies.

4.1.1.3 Trustees

A Trustee or Trustee Company is appointed when the AIF is constituted as a Trust. However, there is no requirement for appointment of a Registered SEBI Trustee under SEBI (Alternative Investment Funds) Regulations, 2012. Though these Regulations do not specifically provide for the qualification requirements or certification or legal form for trustees, they do have laid down the code of conduct for trustees. SEBI reviews the appointment of the trustee at the time of registration of the AIF and subsequent changes need to be notified and approved by SEBI.

The trustee should be a person of ability, integrity and not be guilty of moral turpitude, any economic offence or violation of any securities law. The trustee cannot be the manager, director (including independent director), officer, employee of an investment management company.

The trustee shall ensure that all transactions entered into by the managers are in compliance with the regulations and the scheme's objectives and intent, and shall ensure that the interests of the investors are not compromised in any dealings with distributors, other service providers and even unit holders of other schemes in the AIF.

4.1.1.4 Investment Manager

Manager is the entity that is appointed by the Sponsor of the AIF, to manage its investments and may also be same as the sponsor of the Fund. The Manager should have the necessary skill and expertise to identify favourable investment opportunities and have adequate experience in financial services, investment planning, portfolio management and investment management.

Managers should be able to frame a suitable investment strategy, as per the economic cycles, market sentiments, time horizon and exit strategy or redemption plan of the fund. Managers also need to keep investors informed of the progress of the fund, investments made, key terms of the fund, new developments in the industry impacting the fund, launch of follow on funds and so on.

Managers should satisfy the requirements of 'fit and proper person' based on the criteria specified in Schedule II of the SEBI (Intermediaries) Regulations, 2008. Any change in the appointment of Manager shall be informed to SEBI and where there is a change in control of the investment management company, prior approval from SEBI is required to be taken by the AIF. As per SEBI (Alternative Investment Funds) Regulations, 2012, the AIF appoints an asset management company which manages and plays the role of an investment manager for the AIF. In limited liability partnership (LLP) structure that is widely prevalent abroad, the investment managers (individuals involved) are known as general partners (GPs) or designated partners.

The Sponsors and/or Managers and/or Trustees of AIF have the following general obligations and responsibilities, to ensure transparency:

- **Appointing a Custodian:** The Sponsor or Manager of an AIF shall compulsorily appoint a custodian, registered with SEBI, for safekeeping of securities and shall keep custody of securities and goods received in delivery against physical settlement of commodity derivatives.
- **Review Policies and Procedures:** The Sponsor or Manager shall review policies and procedures of the AIF, along with its implementation, on a regular basis. This enhances transparency and allows investors to take informed investment decisions.
- **Audited Financials:** Books of accounts of the AIF shall be audited annually by a qualified auditor.
- **Dispute Resolution:** The AIF, along with its Sponsor and/or Manager shall lay down appropriate procedures for resolution of disputes between the investors and the Fund, whether through arbitration or any such mechanism as mutually decided between the investors and the Fund.
- **Maintenance of Records:** The Sponsor and/or Manager of the AIF is required to maintain, for a period of 5 years after the winding up of the fund, records such as assets under the scheme/fund, valuation policies and practices, investment strategies, details of investors and their capital contribution and investment decision-making process.
- **Inspection:** Sponsors and Managers are required to co-operate with SEBI by providing all required information for conducting inspection of records of the AIF with respect to activities of fund, assessment of systemic risk or prevention of fraud.

The Sponsor/Manager is obliged to address investor complaints, provide any information sought by SEBI, maintain necessary records, ensure transparency and take all steps to address conflict of interest as specified in SEBI (Alternative Investment Funds) Regulations.

The Sponsor and Manager/Trustee of an AIF have a fiduciary duty towards investors in the fund. They are bound to disclose all conflicts of interests as and when they arise or are likely to arise. Every AIF shall have a Conflict of Interest Policy, which helps to identify and mitigate the potential conflicts. Managers and Sponsors have the responsibility to monitor the compliance towards the conflict of interest policy.

AIF can have potential sources of conflicts at various levels, when dealing with service providers, clients or even with employees dealing on behalf of the fund. The Manager shall envisage every possible conflict during the operations of the Fund. Following are some examples of potential conflicts:

At Fund-Constituent Level:

- Employees of Sponsor Company, Asset Management Company, Trustee and Service Providers should not have potential conflicts, when disclosing material information to their clients.
- Ideally, no potential conflict should prevail between investors and the manager of AIF. However, conflicts may exist that needs to be disclosed and resolved as per conflict resolution policy.
- Employees of all companies shall put the clients' interest over their personal interest. Employees should not solicit gifts, hard/soft commissions, among others.
- Conflicts, within Co-Investments by the Manager, shall be disclosed to the potential investors and existing investors, before any allocation being made towards these investments.
- Disclose the potential conflict if the Trustee is a group or associate entity of the AIF, or sponsor/manager of the fund, or have one or more directors in common.

At Employee or Staff Level:

- Economic interest of the employee, acting on behalf of the AIF, should not be contrary to the best interest of the fund and its clients/investors.
- Employees should not be biased toward the result of the transaction, as a result of a personal, family, friendship or such other relationship with the counterparty.
- The staff member should not be employed, or act on behalf of, another entity which shares the same economic interest or has the same business as the employer organization.

All conflicts, whether present or potential, shall be disclosed to the Compliance function. The Manager should have internal policies within the Fund, to train employees and stakeholders in identifying the conflict, taking the recommended measure as per policy and disclose the same to the Manager. Conflict of Interest Policy should briefly describe the following:

- Nature of potential conflicts of interest which could arise at various levels of the Fund.
- Methodology proposed to be adopted by the Manager for effective mitigation of conflicts.
- Disclosure mechanism to inform investors about the risk arising out of such potential conflicts and seek their acknowledgement towards existence of potential investment risks.

The important aspects of role play of investment managers are as follows –

- **Deal Sourcing** – An AIF manager must identify favorable opportunities, source and complete successful transactions to generate profit and support the raising of further funds. A significant amount of effort and resource is invested in prospecting for transactions and relationship management with external agencies and individuals who may give access to deals. These include investment bankers, chartered accountants, corporate advisers, consulting firms, senior corporate heads and executives, policy makers and others. A large part of the investment manager's time is devoted to networking to create a wider ecosystem for deal generation and execution.
- **Structuring and Investing** – Investment managers need not only be industry specialists but should have very profound deal making skills as well. They have to be keen negotiators and at the same time motivated team leaders to engage with corporate managements and founders of investee companies. They have to create the desired blend of incentives and returns while managing the associated risks.
- **Active Management** – AIF managers have become hands-on managers of their investments. While they do not specifically assume day-to-day management control, they are actively involved in setting and monitoring the implementation of strategy. This is the basis of the argument that AIF investment management is an alternative model of corporate governance to mitigate agency risk in corporate management.
- **Harvest Returns** - The investment managers have to understand the industry and market cycles, their own investment horizon, exit strategy and appropriately harvest returns from their investments. Since AIF is a long-term investment strategy associated with illiquidity in many of the fund investments, harvesting returns by

managing exit risks is probably the most important skill attribute of an investment manager.

- **Relationship Management with Investors** – Investment managers also need to engage skillfully with their investors such that they are always kept informed of the progress of their fund, new developments shaping the AIF scenario and their fund in particular, launch of follow on funds and so on. This would require timely, regular and appropriate engagement strategy.

The fund managers being executives of the investment management company earn the following remuneration for the services rendered –

- A salary from the investment management company.
- A profit sharing or bonus if any, from the profits of the investment management company.

The investment management company earns the following remuneration for the services rendered to the AIF –

- Management fees
- Additional returns if any, from the AIF based on performance of the fund and the terms of the investment agreement
- Share of exit loads and other fees as may be defined in the PPM.

In an **LLP** structure of an AIF, the investment managers are also partners, along with the investors in the fund. In such a situation, the managers are also contributories to the AIF like other investors and their share of the AIF returns would also be available to them as per the terms of the partnership agreement. In the Indian scenario, such contribution is mandatory under the appropriate regulations.

4.1.2 Crowdfunding and Corporate Venture Funding

“Crowdfunding is the use of small amounts of capital from a large number of individuals to finance a new business venture”.²⁴ SEBI in a consultation paper²⁵ has defined crowdfunding as “a solicitation of funds (small amounts) from multiple investors through a web-based platform or social networking site for a specific project, business venture or social cause.”

²⁴ Definition from Investopedia.

²⁵ https://www.sebi.gov.in/sebi_data/attachdocs/1403005615257.pdf Source - <https://taxguru.in/corporate-law/crowdfunding-regime-india.html>

With the emergence of social media as a cost-effective platform for dissemination of information, it has become feasible for small scale entrepreneurs and start-up founders to appeal to a wider section of the society to raise capital for a stated purpose or to finance a business venture. Crowdfunding is enabled through a technology platform which acts as an intermediary to connect fund seekers with potential investors / donors. As far as start-up businesses are concerned, crowdfunding acts as a catalyst for seed stage financing. Though crowdfunding may be used for commercial as well as social enterprises, donations are largely for social causes while loans and equity investments are meant for commercial businesses. So far, crowdfunding has proved effective for objectives that have a social or humanitarian appeal rather than a business venture. Loans sought through crowdfunding are known as 'Peer-to-Peer Lending or P2P Lending' which fall under the regulatory purview of the RBI. Equity crowdfunding is quite uncommon in India due to the prevalence of private placement regulations in India.²⁶ In addition, when business ventures require higher amounts of capital, crowdfunding can prove to be infeasible and may exceed the permissible levels. SEBI in its consultative paper (ibid) highlighted the benefits of crowdfunding for start-ups as it reduces the cost of capital by diversifying risk among a large number of retail investors. However, SEBI has also highlighted the associated risk of exposing retail investors to early-stage financing of businesses. There would also be no standardisation of disclosures and transparency to make informed investment decisions. Currently, there is a minimum prescribed amount i.e. INR 1 crore (INR 25 lakhs for Angel funds) for all AIFs which needs to be invested by each investor.

Corporate Venture Capital (CVC) is defined by the Business Dictionary as the "practice where a large firm takes an equity stake in a small but innovative or specialist firm, to which it may also provide management and marketing expertise; the objective is to gain a specific competitive advantage". CVC has been around for a fairly long time and has been used by large corporates such as Microsoft and Intel to nurture technology start-ups that innovate and prove to be synergistic with their own domains. The essential difference between venture capital and CVC is that VC is a pooling concept while CVC is an on-balance sheet investment by a corporate entity. Hence venture capital investing is a part of the financial industry while CVC is in the nature of strategic investment by a company in any domain.

4.1.3 Co-investments

Co-investments are a unique market practice in the AIF industry. As per SEBI (AIF) Regulations, co-investment means investment made by a Manager or Sponsor or investor of

²⁶Section 42 of the Companies Act 2013 read with The Companies (Prospectus and Allotment of Securities) Rules, 2014.

Category I AIFs and Category II AIFs in investee companies where such Category I AIFs and Category II AIFs make investment, provided that Co-investment by investors of AIF is made through a Co-investment Portfolio Manager as specified under SEBI (Portfolio Managers) Regulations, 2020.²⁷ Under this arrangement, an investor gets the right to directly invest in an investee company in parallel to the investment being made by the AIF. For this purpose, the investor negotiates the special right of co-investment with the AIF at the time of subscription to the fund. The rationale for the investor in having such co-investment right is to be in a position to benefit from a larger direct exposure to an attractive investment opportunity that may bring overall improvement in the return on the portfolio. Without the co-investment right, the investor's return depends upon the performance of the scheme alone. Co-investment rights are not a standard feature and these are generally offered to preferred investors by the fund managers.

4.1.4 Service Providers

AIFs generally have a manager and its key investment team and research associates on their pay-roll. Performing operational activities may fall beyond the bandwidth for such small team-sizes, generally consisting of 5 to 10 employees for a mid-sized fund. AIF, thus, appoints various service providers for other activities related to the fund. These service providers are as follows:

4.1.4.1 Merchant Bankers

Merchant bankers are appointed by the fund to perform various activities related to launch of schemes. AIFs shall file the Private Placement Memorandum (PPM) with SEBI through a SEBI registered Merchant Banker only, at the time of seeking registration or launching new schemes.²⁸ However, intimation with respect to specific change in the terms of PPM may not be required to be submitted through a merchant banker and may be filed directly with SEBI.²⁹

As per SEBI (AIF) Regulations, a merchant banker, so appointed by the fund, shall not be an associate of the AIF, its sponsor, manager or trustee. The following services are performed by merchant bankers:

- Merchant banker conducts independent due diligence of all the disclosures and its adequacy in the PPM and also provide a due diligence certificate which is required

²⁷ SEBI (Alternative Investment Funds) (Fifth Amendment) Regulations, 2021 w.e.f. December 8, 2021.

²⁸ As per SEBI Circular No. SEBI/HO/IMD/IMD-I/DF6/P/CIR/2021/645 dt. October 21, 2021.

²⁹ SEBI Circular No.: SEBI/HO/AFD/PoD/CIR/2024/028 dated April 29, 2024.

to be filed at the time of launching a new scheme or a fund or annual updates of PPM.

- Sponsor/ Manager of the fund, through a merchant banker, files the draft PPM to SEBI for their comments at the time of first or any subsequent scheme launches.
- Merchant banker ensures to incorporate the comments, received from SEBI, in the final PPM prior to launch of the scheme.

4.1.4.2 Registrar and Transfer Agents

Subscriptions and redemptions made by different class of unit holders must be accounted for, by AIF. The Registrar and Transfer Agent (RTA) is responsible to oversee the functions such as the issue of new class of units, partly-paid units, transfer of units, full and partial redemption calls, payment of exit load, expenses and fees by the selling unit holder, etc. In addition to these functions, RTAs have expanded their scope of operations, as some established companies also offer secretarial and administration services, along-with the traditional services.

The Central Government has notified the Registrars to Issue and/ or Share Transfer Agents (RTAs) to act as collecting agents.³⁰ In this regard, SEBI issued a circular stating that all RTAs registered under the SEBI (Registrars to an Issue and Share Transfer Agents) Regulations, 1993 shall be acting as 'collecting agents' to collect stamp duty on issue, transfer and sale of units of AIFs.³¹ Therefore, appointment of RTAs by an AIF is made compulsory to enable collection of applicable stamp duty.

4.1.4.3 Custodian

Asset allocators need to consider depositories and custodians not only in the context of the securities that they hold but also with regard to the safekeeping of assets underlying the investment pools in which they invest. As part of this role, the custodian needs to accept and give delivery of securities for the regular investment transactions of the fund. Since securities held by AIFs are in dematerialised form, the custodian is responsible for settlement of transactions and ensuring that the dematerialised investment accounts of the fund reflect the correct position at any time. The custodian may perform additional activities, such as tax withholding, proxy voting and also track corporate actions such as dividends, bonus and rights issues in companies where the fund has invested.

³⁰The amendments to the Indian Stamp Act, 1899 brought through Finance Act, 2019 and Rules made thereunder w.e.f. 1st July, 2020 vide notifications dated March 30, 2020.

³¹SEBI Circular No.: SEBI/HO/IMD/DF6/CIR/P/2020/113 dated June 30, 2020 on Collection of Stamp Duty on issue, transfer and sale of units of AIFs.

All custodians need to register with SEBI under the SEBI (Custodian) Regulations 1996. As per SEBI (Alternative Investment Funds) Regulations,³²

- i. Sponsor or Manager of AIFs shall compulsorily appoint a custodian for safekeeping of securities of the fund.
- ii. Custodian, appointed by the Sponsors or Managers of Category III AIFs shall keep custody of securities and goods received in delivery against physical settlement of commodity derivatives.³³
- iii. Custodians shall report information regarding investments of AIFs as specified by SEBI.

The custodian is appointed by the sponsor or manager of the AIF. Also, custodians for a scheme of an AIF shall be appointed prior to the date of first investment of the scheme.³⁴ A custodial agreement is entered into between them. As per SEBI (Alternative Investment Funds) Regulations, the custodian shall not be a related party to the sponsors or designated partners, unless specific conditions are fulfilled.³⁵

4.1.4.4 Fund Administrators or Fund Accountants

Fund Administrators play a crucial support function to Manager of AIFs. They perform the following support activities:

- Maintenance of funds books and records and compliance with statutory requirements.
- Accounting and allocation of income and expense accruals
- Providing global regulatory compliance reporting solutions
- Providing Tax reporting solutions and services
- Conducting NAV calculation, valuation services and Risk Reporting
- Providing access to database vendors, assisting with dealing-related enquiries and providing information relating to funds, securities, prices and dealing procedures
- Preparing manual and electronic payment instructions to settle fund expenses and maintaining an electronic payments library to ensure daily reconciliation of all cash and security balances
- Preparing and distributing investment manager statements, interim financial reports and annual reports
- Providing necessary support to fund auditors

³²SEBI (AIF) (Amendment) Regulations, 2024 w.e.f. January 5, 2024.

³³Vide SEBI (Alternative Investment Funds) (Amendment) Regulations, 2019 w.e.f. May 10, 2019.

³⁴SEBI Circular No. SEBI/HO/AFD/PoD/CIR/2024/5 dated January 12, 2024 on Guidelines for AIFs with respect to holding their investments in dematerialized form and appointment of custodian.

³⁵Vide SEBI (AIF) (Amendment) Regulations, 2024 w.e.f. January 5, 2024.

Many foreign funds have the support functions of fund administration, performed through Fund Administrators established in India. It would be pertinent to note that Fund Accountant or Fund Administrator is not a regulated function in India unlike in other developed markets. Custodian also, typically, offers the said services along with its custody services and offerings. There are several other vendors which can also be used, or the functions can be performed in-house, if the number of investors is small or NAV computation is not that frequent within the fund.

4.1.4.5 Fund Infrastructure

AIFs depend on robust platforms and software for their efficient functioning. State-of-the-art technology and infrastructure are one of the most important success factors for Investment Managers, in today's technology-driven world, as they seek data dissemination from global markets, segments and geographies. Mitigation of cyber-crime risks and frauds is also a concern for Investment Managers, as they are responsible for client data in their fiduciary responsibility.

Category I and II AIFs use databases for fundamental analysis like Preqin, Tracxn, Bloomberg, LSEG, etc.

4.1.4.6 Distributors and Placement Agents

One of the key developments that would shape the growth and proliferation of the AIF industry in India would be the role played by distributors and placement agents, just as in the case of the mutual fund industry which grew phenomenally in India since 1994. They are important in not only the selling function but in the creation of wider awareness and familiarity among the investor community with regard to AIF products, services, investment strategies and their return potential.

A distributor can be empanelled with more than one AIFs. Distributors can be individuals or institutions such as distribution companies, broking companies and banks. However, AIF product distribution skill requires proper training and thorough understanding of the industry and the products. AIF investors are meant to be sophisticated investors with higher risk appetite. As AIFs bear a higher risk of investment, investors also need higher risk-taking ability and willingness to invest in such assets. Distributors have to understand the risk-return profile and suitability of every scheme, launched by AIFs, for the investors/clients on a case-to-case basis. They should have a complete understanding of the operations of AIF,

the investment strategy deployed, targeted asset classes, industries and sectors for investments, which can help them map the requirements of investors with the funds they distribute.

4.1.4.7 Tax Advisors

Tax Advisors are appointed by AIF managers to get advice on various aspects of fund management and transactions including domiciling the funds. Offshore Funds, in tax-friendly jurisdictions, have proved to be beneficial for investors and avoid cascading effects of taxation for AIFs. Tax Advisors also serve investors, typically foreign portfolio investors, in fund structuring, deal structuring, tax compliance and due diligence, when they look to invest in domestic AIF market or related securities. For Indian AIF, tax advisors would typically help the funds in calculating pre and post tax NAV, estimating advance tax and tax deducted at source and various other aspects.

4.1.4.8 Legal Advisors

Drafting of legal agreements and legal documentation is done by third-party legal advisors or in-house legal counsels appointed by the AIF. Legal agreements are the basis of the contract between the Investors and the Fund. Depending on the structure of the fund entity, geographical location and targeted investor, legal advisors are responsible to draft the legal documents. Fund structures may sometimes be complex, which can require a number of agreements and legal documents to be signed by various stakeholders in the AIF.

4.1.4.9 Auditors

Statutory auditors, PPM auditors and Internal auditors are appointed by AIFs as they sign-off on the financial statements, Annual PPM Audit and internal audits, as the case may be. All the books of accounts of the AIF shall be audited annually by a qualified auditor, similarly PPM audit is mandated each year to be performed by a practising CA or CS.

4.1.4.10 Investment Advisors

Offshore funds may seek investment advisory services, especially when looking to invest in domestic markets and in niche industry sectors. Domestic investment advisors sign

investment advisory agreements to seek best execution for their clients. They provide industry-specific insights and potential investee companies, commensurate with the risk-return objectives and investment constraints of the Fund. It would be ideal to note that these are non-binding advice and investment manager may choose to execute or leave the same. The Investment Advisors are paid advisory fees from the investment manager for their services. Domestic funds do not generally have the practice of appointing investment advisors.

4.1.4.11 Independent Valuers

AIF Managers appoint independent valuers to compute and carry out valuation of the investments of the scheme of the AIFs in the manner specified by SEBI. Independent valuers should have a minimum of 3 years of experience in valuation of unlisted securities.

4.1.5 Capital Commitment and Sponsor Commitment

Capital commitment refers to the total funds to be contributed by investors for subscription to AIF, during the life of the fund. Individual capital commitments of each investor are based on their capital allocations to AIF, which may be different for institutional investors and non-institutional investors. Under the SEBI (Alternative Investment Funds) Regulations, 2012, an AIF shall not accept from an investor, a capital commitment of value less than INR 1 crore.³⁶ However, if the investors are the employees or directors of the AIF or the employees or directors of the Manager, the minimum investment value by such employees or directors is INR 25 lakhs. Each scheme of the AIF shall have a total corpus, i.e. total of capital commitments raised from investors, of a size of not less than INR20 crore. Under existing SEBI guidelines, units of an AIF can only be allocated after receipt of money/payment of stamp duty of the commitment from the investor either on a fully or partly paid up basis, as the case may be.

Partly paid-up units shall represent the portion of committed capital invested by the investor in AIF or schemes of the AIF. Capital commitment provides certainty of funds to the manager so that investments can be planned accordingly. Usually, a commitment period is specified in the investment agreement, during which the capital committed is called-up by the manager, by making 'capital calls'.

³⁶ Not applicable to Accredited Investors, as per SEBI (Alternative Investment Funds) (Third Amendment) Regulations, 2021 w.e.f. August 3, 2021.

Thus, capital commitment is only the legally binding commitment for a certain amount against future opportunities a fund manager selects for the fund or a particular scheme under the fund. Investors do not deposit the cash with the fund manager. In India, capital commitments have been a combination of both the 'blind pool' structure and other innovative arrangements on a deal-to-deal basis such as co-investments. Blind pool structure would mean that capital is committed by the investor to the overall fund and specific investments are made by the manager.

Sponsor commitment is the financial investment required from the sponsor or the manager of the AIF. This commitment from the sponsor / manager is necessary to demonstrate the alignment of interests between them and the AIF, so that the investors are assured of their best interests being taken care of in the future. As per the SEBI (Alternative Investment Funds) Regulations, 2012, the Sponsor or Manager shall have a continuing interest in AIF of:

- not less than 2.5 percent of the corpus of the fund or INR 5 crore whichever is lower, for Category I and Category II AIFs
- not less than 5 percent of the corpus of the fund or INR 10 crore whichever is lower, for Category III AIFs.

The commitment shall be in the form of fresh investment in the scheme of the fund and shall not be through the waiver of management fees or transfer of stocks. In other words, the commitment shall be demonstrated through a cash investment by the Fund Sponsor or Manager and putting their capital at risk on par with that of other investors in the fund, till end of the tenure of the fund. The Manager or Sponsor shall disclose their investment in the AIF to the investors. Such continuing interest cannot be withdrawn from the fund and will remain locked-in until distributions to investors are completed in full. Therefore, the sponsors are the first investors to commit to the fund corpus and would also be the last to be paid out upon winding up. Sponsors may also need to invest more in subsequent tranches to maintain their minimum regulatory commitment if the fund size goes up. The sponsors can choose to invest higher than the above mentioned amounts in the fund, however, they will only be able to withdraw the same after all investors have been paid out.

4.1.6 Drawdown and Capital Invested

Drawdown is the process by which a fund manager will call the capital commitment from the investors as and when the funds are required for investment activity under the fund. These are known as 'capital calls'. Drawdown is usually made during the defined drawdown period through a process mutually agreed with the investors whereby a 'drawdown notice' is issued making it necessary for investors to deposit funds. Drawdown notice would indicate a date by which the payments have to be made (periodic intervals or ad-hoc), the method of payment, applicable interest fee and penalties in case of failure to honour the capital calls

and other necessary details. Since drawdowns are subject to the investment requirements of the fund manager, it makes it particularly difficult to forecast from a cash perspective for the investors. Investors have to keep available cash resources during the agreed drawdown period anticipating drawdown calls from the investment manager. In some cases, it is possible that the total drawdown may not reach the committed capital level due to the inability of the fund manager to find adequate number of investment opportunities. Similarly, it is possible in a given case that an investor has failed to deposit the committed fund in response to a drawdown notice due to timing issues. Normally, investment managers protect themselves from the risk of an investor being unable to fund their commitments by putting in place a mechanism whereby if a particular investor cannot fund a drawdown, other investors take up the drawdown call. The investors who fail to fulfil their commitment then substantially lose their rights and returns under the investment agreement. This event is called 'default in drawdown' under the agreement. The options under the agreement in such an event could be to reduce the capital commitment, or charge interest for delayed payment or in extreme cases, terminate the agreement and return the capital invested so far.

It is customary that investors are provided details of how drawdowns are proposed to be made by the investment manager such as the following -

- Purposes for which a drawdown can be made
- Schedule of drawdown e.g. initial drawdown, fixed periodic drawdown or drawdown on an *"as-needed"* basis during the commitment period.
- Notice period (number of days for the drawdown of capital) upon serving drawdown notice
- Class wise drawdown and the associated timelines, for e.g. if the unit capital has different classes with different rights attached to them, the drawdowns can be specific to each class of units.
- Mode of issuance of drawdown notice
- Return of drawdown, subject to recall of the drawdown amounts (optional)
- Drawdown post commitment period and the manner in which it will be utilised
- The 'initial drawdown', i.e. the first draw down made by the investment manager after the 'first closing' of the fund usually provides for: (i) Management Fees; (ii) organisational and other expenses attributable to the fund; and (iii) the capital contribution to finance investments made if any, prior to such drawdown.

Please note that as per exiting regulations, a fund can't offer differential drawdown terms to investors in the same class.

Capital Invested is the total amount drawdown by the manager, from the investors in the AIF, for the purpose of making investments. For example, an AIF scheme closes with total capital commitment of INR 1000 crore. As and when investments are ready for being financed, the manager will issue drawdown notices to the investors to deposit the capital call payment with the fund. At a given time, if the total drawdown amount is INR 650 crore, the 'Invested Capital' of the AIF would be INR 650 crore, as against a 'Committed Capital' of INR. 1000 crore. The undrawn amount of INR. 350 crore is known as 'Dry Powder or pending drawdowns'.

4.1.7 Due Diligence

In legal parlance, due diligence is generally defined to mean processes that ensure enough safeguards are taken and reasonable care is exercised in protecting the interests of the party, conducting investigation or due diligence and to avoid harm to third persons or their property. Due diligence is of high significance in matters relating to investments, securities markets and corporate businesses. Alternative investments require even greater care in meeting the challenges of performing due diligence.

Due diligence is necessary to be conducted at two levels:

- **At the fund level:** When investors or unit holders need to subscribe to the corpus of the AIF, it is imperative to perform due diligence on the operational risks, market risks, regulatory and compliance risks, strategy risk and reputational risk faced by such funds.
- **At investee company level:** Financial and Business due diligence is significant from the perspective of the AIF, to understand the investment risks in the proposed investment that is being marketed to a prospective unit holder.

4.1.8 Environmental, Social and Governance

Environmental, Social and Governance (ESG) is a generic term for evaluating corporate behaviour and nowadays used interchangeably with sustainable, responsible, impact or ethical investment. ESG is a fast emerging investment protocol in the world of corporate investments, more emphatically in the realm of alternative investing. It may be viewed as a successor to Socially Responsible Investment (SRI), which is gaining popularity worldwide. But unlike SRI, which relies on negative screening, ESG propounds an underlying philosophy of larger good without overlooking financial or economic viability. Corporate Social

Responsibility (CSR) – an India economy/regulatory phenomenon that is often mistaken for ESG – is actually only a small part of ESG.

ESG norms are progressively defining the way businesses should operate, particularly in developed markets. Over the recent years, global investors have been embracing responsible investing, which involves incorporating ESG factors into investment processes. By supporting companies that are compliant with ESG parameters, investors can help create a positive ecosystem of responsible businesses, which do the right things and attract the right kind of investors, employees, customers and other stakeholders. In India several established players are in the process of launching ESG compliant funds and several offshore AIF investors investing through off-shore funds or domestic AIFs are also seeking ESG compliant investing themes.

The United Nations backed Principles for Responsible Investment (PRI) is a global network of investors that attempts to integrate ESG practices into investment practices. In 2006, the UNO launched the PRI based on the notion that an ESG approach can affect the performance of investment portfolios and should, therefore, be considered alongside more traditional financial factors if investors are to properly fulfil their fiduciary duty. The PRI signatories are expected to follow these principles, thereby aligning investment activities with interests of the society. Globally, green bonds (to fund energy efficient projects), blue bonds (to fund marine protection), environmental impact bonds and ESG-themed exchange traded funds have been launched over the past one decade. According to a recent report by Bloomberg Intelligence, ESG and sustainability-focussed ETFs should continue to grow based on niche themes such as low-carbon, climate and gender. According to reports, there is strong research evidence of ESG investing delivering superior returns since companies with strong sustainability scores demonstrate better operational performance and are less risky.

ESG indices in the US were launched in early 1990s—MSCI KLD 400 Social Index in 1990 and several thereafter over the next 15 years. In India, ESG indices debuted only recently in 2012 (such as MSCI India ESG Leaders Index, S&P BSE 100 ESG Index, NIFTY100 ESG Index). The recent ESG index launched in the US and Europe is based on specific social or governance themes or impact investing. Thematic ESG indices show that the two geographies are ahead of the curve, also indicating an investment shift away from broad-based indices. India, currently in the nascent phase of ESG investing, understandably shows a skew towards broad-based ESG indices.

As far as India is concerned, considering the growing importance of ESG compliance in business domain, regulations are already moving in that direction. In August 2012, SEBI issued Business Responsibility Reporting (BRR) norms for the top 100 listed entities, thereby stipulating non-financial reporting by corporate India. The BRR norm was later extended

gradually to the top 500 and top 1000 listed entities by market capitalisation. The BRR captures an organisation's non-financial performance across economic, environmental and social factors. This reporting requirement is in line with the 'National Voluntary Guidelines on Social, Environmental and Economic Responsibilities of Business (NVGs)' notified by the Ministry of Corporate Affairs, Government of India, in 2011. These guidelines contain comprehensive principles to be adopted by companies as part of their business practices and a structured business responsibility reporting format requiring certain specified disclosures, demonstrating the steps taken by companies to implement the said principles. Further with increased focus towards sustainability investing globally, SEBI reviewed the BRR norm and improved the ESG related disclosures with the introduction of Business Responsibility and Sustainability Reporting (BRSR).³⁷ The BRSR is intended towards having quantitative and standardised disclosures on ESG parameters to enable comparability across companies, sectors and time. Disclosures as per the BRSR are mandated for top 1000 listed entities by market capitalisation effective from FY 2022-2023. SEBI further issued a circular which mandated 9 specified Key Performance Indicators (KPIs) for ESG reporting under the BRSR regime for the value chain of a company's business.³⁸ Disclosures for value chain shall be made by the listed company as per BRSR Core, as part of its Annual Report. For this purpose, value chain shall encompass the top upstream and downstream partners of a listed entity, cumulatively comprising 75% of its purchases/ sales (by value) respectively. SEBI also introduced comprehensive regulation for ESG Ratings and ESG Rating Providers (ERPs).³⁹ These provisions provide for types of ESG Ratings/ Scores, business of ERPs, rating process, disclosures and reporting and connected matters.

Considering that capital markets, mutual funds and regulations are also leaning more towards ESG sensitive companies, the importance of ESG as a theme for AIF ecosystem investing is going to be bigger in the coming years.

SEBI has introduced a Stewardship Code for all categories of AIFs, in relation to their investments in listed equity securities.⁴⁰ It is imperative for AIFs to follow the principles mentioned in the code, when evaluating potential investments and evaluating ESG risks for each investee company.

The Stewardship Code is based on the following five principles:

³⁷ Vide SEBI Circular No.: SEBI/HO/CFD/CMD-2/P/CIR/2021/562 dated May 10, 2021 on Business responsibility and sustainability reporting by listed entities.

³⁸ SEBI/HO/CFD/CFD-SEC-2/P/CIR/2023/122 dated July 12, 2023.

³⁹ SEBI/HO/DDHS/POD2/P/CIR/2023/121 dated July 12, 2023.

⁴⁰ SEBI Circular No.: CIR/CFD/CMD1/168/2019 dated December 24, 2019 on Stewardship Code for all Mutual Funds and all categories of AIFs, in relation to their investment in listed equities.

- **Principle 1:** AIFs should formulate a comprehensive policy on the discharge of their stewardship responsibilities, publicly disclose it, review and update it periodically.
- **Principle 2:** AIFs should have a clear policy on how they manage conflicts of interest in fulfilling their stewardship responsibilities and publicly disclose it.
- **Principle 3:** AIFs should monitor their investee companies.
- **Principle 4:** AIFs should have a clear policy on intervention in their investee companies. AIFs should also have a clear policy for collaboration with other institutional investors where required, to preserve the interests of the ultimate investors, which should be disclosed.
- **Principle 5:** AIFs should have a clear policy on voting and disclosure of voting activity.

Stewardship responsibilities include monitoring and actively engaging with investee companies on various matters such as financial performance, operational risk, strategy, corporate governance, board structure, remuneration, etc. and material ESG opportunities and risks.

4.1.9 First close and Final close

When investment managers launch a new AIF, or a new scheme of the fund, they usually set a target minimum corpus to be raised, based on the investment strategy and theme. Once the Manager is successful in raising commitments over the minimum corpus or has completed a stipulated period of fund raise, it may declare a 'first close'. This represents a commitment by the AIF to proceed with the fund and is also a positive signal for other investors who may be monitoring the fund raising process with the intent of investing in future.

The manager retains the right to accept subsequent contributions from investors and declare subsequent close dates. The terms of the fund will specify that the 'final close' would happen not later than a specified period after the first close, with necessary approvals.

4.1.10 Green Shoe Option

'Green Shoe Option' is a term associated with overselling or over-allotment of securities in a public offer by a company to raise capital. For e.g. if a company has set out to raise INR 200 crore by a share sale through a public offer but has received an overwhelming response from investors, a green shoe option if exercised, enables the company to retain more than the targeted amount subject to certain conditions. Green shoe option regulation is normally

used for all types of capital raises by companies, mutual funds, infrastructure debt funds, AIFs and other entities that are allowed to raise capital.

In the AIF context, the most commonly found structure is that of a trust which raises its targeted corpus by selling its unit capital to investors through a private placement as per the AIF Regulations. During such capital raise, if the AIF's investment theme strikes the right chord with potential investors, it has been observed in many cases that the AIF's scheme received contribution commitments that far exceeded the target corpus. In such cases, the AIF may decide to increase the fund size to accommodate additional contributions. In order to be able to do so, the Placement Memorandum should have a provision for the exercise of a green shoe option. The AIF Regulations do not have any express provision on the exercise of a green shoe option but normal disclosure standards do require such a green shoe option disclosure in the Placement Memorandum. The green shoe option may be exercised before the final close of the fund even if the first close has already been completed.

4.1.11 Fees and Expenses

AIFs are professionally managed by Managers, who charge a certain fee, over and above the fixed management fees and other expenses charged to the fund. The fees and expenses charged to investors of an AIF are discussed below:

4.1.11.1 Fund Tenure

According to SEBI (AIF) Regulations 2012, Category I and II AIFs shall be structured as closed-ended funds .. A closed-ended AIF generally has a minimum tenure of 3 years. The Manager of the AIF mentions the conditions applicable for redemptions, in the PPM.

4.1.11.2 Management Fees

The reference to fees and expenses applies primarily to the management fees and expenses chargeable to the AIF, as per the investment management agreement (IMA) between the fund and the manager. Management fee is paid by the fund to the manager, which usually ranges between 1 percent and 2.5 percent per annum of the capital committed during the commitment period. Thereafter, it reduces to a fixed percentage of the actual invested capital, if it is lesser than the committed capital, or as a percentage of the underlying value of the assets under management (AUM) of the fund. The percentage of management fees charged can also be fixed on a slab-rate system, wherein the percentage of management fee reduces, as the investor commitment increases. Further, investment managers also have the

right to charge different management fee percentages to different class of units or investors, based on minimum subscription amounts to the fund, or on the class of units issued in sequential order.

Management fees is payable to the manager even if the AIF generates no profits and no returns. Goods and Services Tax (GST) is payable on the management fee and is usually charged over and above the stated management fee percentage. Disclosures on fee structure are made in the PPM and the terms of the investment agreement.

The function of investment management is performed by the investment manager and accordingly, all such associated costs have to be borne by the manager and cannot be charged to the fund. Such expenses may include lease or rental charges, office maintenance, travel and outsourced support services, investment due diligence, transaction documentation costs pertaining to deal execution and such other costs.

4.1.11.3 Set-up Costs and Operational Expenses

Manager of an AIF can charge a one-time Set-up Cost to investors. These costs are directly attributable to the formation of the Fund and initial sale of units of the fund, including external legal and accounting expenses, statutory compliance costs directors' fees, printing costs and reasonable out-of- pocket expenses incurred by the Investment Management team. GST and other statutory charges are levied on the set-up costs.

AIF and the Manager incurs operating expenses in relation to their engagement with external service providers, administrative costs, tax expenses, compliance costs and expenses incurred for daily operations of the fund. Usually, investors insist on caps specified to each head of expenses or the overall expenses chargeable to the fund during its life or on annual basis.

4.1.11.4 Hurdle rate and High-Water Mark

Hurdle Rate of Return, or 'Preferred Return', is the threshold return that the investors in the AIF must receive, before the manager receives additional returns, if any. The purpose of having a hurdle rate is to benchmark the expectations of the investors, rather than to provide a guaranteed return to investors, which is neither ethical nor practically possible.

AIFs should compensate investors for taking higher risk of illiquidity and longer term of holding. Hence, hurdle rates have to be better than comparable market returns in traditional investments. Hurdle Rate can be correlated with the opportunity cost for an investor, which can be a fixed return per annum or based on a reference asset or index, identified by the Manager.

High-Water Mark is the higher of the subscription price of units issued to a particular class of investors, or the highest NAV achieved at the end of any previous financial years. High-Water Mark is important for the purpose of computing the incremental returns, earned by the Manager of an AIF.

4.1.12 Additional Returns and Performance Fees

‘Performance Fees’ or ‘Incentive Fees’ is provided to the manager as an incentive to outperform the hurdle rate as well as the high-water mark of the units issued to a particular class of investors. The Additional Return (known as ‘carried interest’ or simply ‘carry’ in international markets) for the fund is calculated as the difference between the AUM of the fund and the higher amount of Reference Hurdle or the High-Water Mark, as at the end of the financial year. ‘Performance Fees’ is paid to the manager, as a percentage of the Additional Return, which is generally up to 20 percent of the additional return. This is the reward for the Manager for maximising the return for investors in the AIF.

Managers can charge performance fees in the range of 0 to 30 percent. Most AIFs charge a Performance Fee of 20 percent, being structured as ‘2-20’ Fund implying that the manager gets 2 percent management fee and 20 percent additional returns. However, the ‘2-20’ structure is not a standard in the evolving Indian AIF market. The payment of additional returns and the quantum thereof, depends entirely on the credibility and track record of the sponsor / manager, type of fund, investment strategy and size of the corpus.

Performance Fees is assessed on exits made by the manager and are payable only upon liquidation of the fund, if the fund is structured as a closed-ended fund. The fund terms would specify if additional return is calculated on deal-by-deal basis or on aggregate portfolio basis to determine its amount.

4.1.13 Distributions / Waterfall

The distribution terms of an AIF are one of the most important areas of understanding for potential investors as they determine how the proceeds of the fund will be returned back to investors, in what proportion and priority, and how managers adjust their fee and additional returns or incentives if any, from such distributions. Unless these terms are understood well, the investor may miscalculate the return pay-outs. Therefore, the ‘distribution terms’ of the fund are to be read and understood carefully from the PPM before investing.

Distribution terms follow a priority sequence of payment as determined under the terms of the fund (known as the 'waterfall'). There are basically two types of waterfall – European Waterfall and the American Waterfall. Under the **European Waterfall**, 100% of all investment cash flow (i.e. the invested corpus) is paid out to investors on a pro rata basis and thereafter the preferred return is paid out in full as the first and second priority payments respectively. Pro-rata means that all capital is treated equally and distributions are paid out in proportion to the amount of capital invested. An individual who contributed 10% of the invested capital would be entitled to 10% of the distributions until he has received back 100% of his contribution plus the preferred return. Thereafter, the investment manager gets to receive the additional return or carry. If the manager has a 'catch up' clause, it will receive the third priority distribution in full until the additional return catches up to the agreed percentage of total return. If there is no 'catch up' clause, the balance distributions will be available to investors and the manager in the ratio of sharing of the excess returns after deduction of statutory dues and other items. The drawback in the European waterfall is that the manager's profit sharing may not get realised for six to eight years after the initial investment. An underpaid manager may be incentivised to seek quicker exits and liquidation rather than maximising the return potential of the fund. In the Indian scenario, additional returns may be paid on a staggered basis depending upon fund performance.

The **American waterfall** structure tries to improve the aspect of waiting time for the manager to earn the carry or additional return. This structure allows for managers to get paid prior to investors receiving 100% of their invested capital with preferred return thereon. Though the entitlement of investors remains the same, the waterfall is adjusted to allow the manager to be paid an incentive fee on each deal, regardless of whether the investor's preferred return and capital have been paid back in full. This structure can help a smaller manager smooth out their income over the life of the fund. To protect investors, there is usually a caveat in the investment agreement that states, the manager is only entitled to take this fee so long as the other assets are performing well and the manager reasonably expects the fund to generate total return in excess of the preferred return. This would usually be mentioned in the distribution section of the PPM. American Waterfall is suitable for pure debt funds wherein the fund's investment theme could primarily be to hold assets to maturity.

In the AIF trust structure in India, it has been noticed that the unit capital is organised generally as Class A units representing investor interests and Class B representing sponsor/manager interests and the distribution waterfalls are prescribed accordingly.

4.1.13.1 Clawback

In order to ensure that there is no moral hazard in the American Waterfall, there is usually a clawback provision built in for investors. Clawback also addresses the problem of both profits and losses occurring through time within a portfolio, some private equity funds have clawback clauses in which performance fees based on early successful exits can be clawed back or recovered by the investors from the manager to offset the losses on subsequent failed investments. Therefore, clawback right entitles investors to reverse any incentive fees taken by the manager during the life of the investment to ensure that fees based on the fund-as-a-whole approach are adjusted to reflect a full netting of profits and losses over its life. However, this clause is only as good as the manager's ability to refund the excess return, so it's important that the manager has high credibility and a balance sheet to support.

In the Indian scenario, it is customary to include a reserve creation in the waterfall to provide for unforeseen tax liability or other charges, especially in funds involving offshore investors. Alternatively, there could be a 'giveback' clause whereby some amounts are adjusted against givebacks by the investors from distributions. Giveback may work better for the manager than creation of reserves as preferred returns need not be provided on the giveback amounts. A lot of AIF typically charge the performance fees at the end of the life of the fund to avoid any clawback on performance.

4.1.14 Term Sheet and Summary of Principal Terms (SOPT)

The Term Sheet is an important milestone in the process of conducting an investment transaction by which the AIF invests in an investee company. This is not a legal agreement and is therefore not binding on both parties. It is the first step in reaching an understanding between the AIF and the investee company which would pave the way for both parties entering into binding investment agreements. The Summary of Principal Terms (SOPT) summarises the main terms and conditions as per which the AIF expresses its willingness to invest in the company. The Term Sheet would be subject to further discussion between both parties and there could be further negotiations to fine tune it. Term Sheet, once executed, usually have a validity period during which the transaction will be completed by both parties.

4.1.15 Private Placement Memorandum

The Private Placement Memorandum (PPM) is the offer document that is issued by the sponsor / manager to the prospective investors in connection with inviting subscriptions for

a fund to be floated / follow on fund / new scheme in an existing fund. The PPM sets out the broad terms and conditions subject to which the fund is proposed to be operated and necessary disclosures in connection therewith. The PPM provides investors detailed information on the principal terms, disclosures on commercial aspects, distribution waterfall, risks associated with the fund investment and so on. The PPM and its contents are discussed more in detail in later chapter.

Sample Questions: Chapter 4

1. The following category of investors is not suitable to invest in an AIF.

- a. Individuals less than 60 years of age
- b. Individuals with no risk-taking capacity**
- c. Members of a HUF
- d. Partners of a firm

2. Which of the following persons is eligible to be the sponsor of an AIF?

- a. Individual who is convicted of a criminal offence but awaiting sentencing
- b. Individual of an unsound mind but undergoing treatment
- c. Individual who is insolvent but is yet to file for bankruptcy
- d. 'Fit and proper' person as determined by SEBI**

3. _____ is a function of the investment manager.

- a. Entrepreneurship
- b. Auditing the books of an AIF
- c. Harvesting returns**
- d. Settling business disputes of the investee company

4. Distributor of an AIF is the vital link between potential investors and the investment managers of an AIF. State whether True or False.

- a. True**
- b. False

5. Sponsor commitment in the context of an AIF means the extent to which the sponsor commits to running its operations according to established business practices. State whether True or False.

- a. True
- b. False**

CHAPTER 5: ALTERNATIVE INVESTMENT FUND STRUCTURING

LEARNING OBJECTIVES:

After studying this chapter, you should know about:

- Principle of Pooling
- Anatomy of AIF constitution (Trust/ Limited Liability Partnership/ Company)
- Various AIF structures
 - Pure Domestic and Pure Off-shore AIF
 - Parallel structure and Unified structure of AIF
 - Feeder Fund structure and Parallel structure of AIF

Introduction

The term 'alternative investment fund structuring' refers to both the constitutional aspects of the AIF and the investment routing options for investors in such funds. Since AIFs have become an important investment route for foreign investors to invest in India, AIF structuring inter alia, should also consider the aspects related to how such offshore investors may invest in India. The following discussion in this Unit dwells on various aspects that are relevant to this structuring process as well as the general templates that are used for AIF funds constituted in India for domestic investors / foreign investors as well as India-centric offshore funds that are incorporated outside India.

After the introduction of the SEBI (AIF) Regulations 2012, the regulatory slant has been towards promoting home-grown investment managers by allowing Indian managed and sponsored AIFs with a mix of foreign investors. The AIF Regulations have thus revolutionised offshore interest in domestic AIF assets and it is presently perceived that the AIF route is the most convenient route for large offshore financial investors to tap alternative investments in India. For domestic investors, the AIF regime provides an effective platform to avail the expertise of alternate fund managers.

5.1 Principle of 'Pooling'

The concept of 'pooling' is central to the formation of any investment management structure and it applies equally in the context of AIFs. When a set of investors having common investment objectives require investment management services, there are primarily two methods of managing the same – (a) Individual Portfolio Management and (b) Pooled Asset Management. Under the former structure, the individual investment corpus of each investor is kept distinct and managed under a portfolio management agreement with the manager.

The portfolio manager either has discretion to take the investment decisions from time to time or every decision is advised to the investor who takes the call depending on whether the management terms are discretionary or non-discretionary. Either way, the essential feature of portfolio management is that it is a customised service offered at individual investor level. Therefore, there would be as many investment management outcomes as there are investors.

In asset management services, there is no concept of an individual corpus. Instead, the contributions provided by investors are 'pooled' together into a common corpus that would be managed by an investment manager. Pooling also helps to bring in economies of scale in investment management by combining individual corpuses into a large common fund. The investment manager can plan a better and broad-based investment strategy with a larger pool of underlying assets to bring in the benefits of risk diversification. The risk-taking capability is also enhanced to bring in the possibility of better returns to the common fund that would be enjoyed by all individual investors participating in it. In short, pooling helps in collective investment management and its attendant benefits. Pooled investment vehicles are therefore fundamental to fund structuring in the AIF industry as much as they are applicable to the mutual fund industry.

5.2 General 'Pooling' Considerations

1. In a pooled investment management structure, it becomes essential to provide a distinct legal identity to the pool separate from its individual investors, the manager and the sponsor or other service providers associated with the pool. Under SEBI AIF regulations, there are primarily three possibilities – (a) formation of a trust under the Indian Trusts Act 1882, (b) a limited liability partnership (LLP) between the investors and the investment manager under the Limited Liability Partnership Act, 2008 and (c) formation of a private or public limited company under the Companies Act, 2013 with investors as shareholders and the representatives of the manager as directors in executive capacity.
2. The pool should have limited liability so that it does not end up taking higher level of risks than those underlying its investment objectives. All the three alternatives mentioned above provide the advantage of limited liability to the pooled vehicle.
3. Pooling should also satisfy the principle of 'tax neutrality', i.e. it should not put an investor in a comparatively adverse position from taxation point of view as compared to investing at individual level. This is especially relevant when certain streams of income may be tax free at investor level due to the status of the investor, but taxable at fund level. Since this outcome depends on the provisions of the tax law, it would

be necessary to optimise the structure as nearly as possible to achieving tax neutrality.

4. Pooling should also be compliant with regulatory requirements of SEBI, foreign investment law and RBI regulations, corporate law and compliance requirements.
5. The structure should not be too complex such that it is perceived to be exploiting regulatory and tax arbitrage and may come under the scrutiny and wrath of regulators. While taking advantage of available options under law, the structure should seem genuine and not to obfuscate the underlying objectives of creation of the pool. From the Indian context, complicated structures are likely to be scrutinised under the General Anti-Avoidance Rules (GAAR) which allows Indian tax authorities to re-characterise transactions on grounds of lack of commercial substance among other things.⁴¹
6. From an offshore investor perspective, the general principles for deciding on the jurisdiction for pooling an India centric fund are the following –
 - a. Since India is one of the high tax jurisdictions in comparison with several other countries, offshore investor prefers to optimise domestic taxation in India on their investment activity. This would partly offset the currency loss they may incur on Indian rupee (INR) depreciation during the investment horizon. Pooling the fund in a jurisdiction that has a good tax treaty with India which would avoid double taxation in India as well as in the investor's country is of primary importance. India has such Double Taxation Avoidance Agreements (DTAAs) with several countries.
 - b. Sometimes, a jurisdiction is also chosen if it has a good Bilateral Investment Promotion Agreement (BIPA) with India (for e.g. Singapore). A BIPA also helps in protecting an investor's financial interests in India in the event of hostilities between the two countries or other repatriation risks. BIPA also generally provides investment incentives to promote mutual interests of both countries.
 - c. Investors may also prefer, in certain situations, to set up their investment vehicle in a jurisdiction that has a globally recognised capital market such as Luxembourg, Singapore, Tokyo, DIFC, ADGM or Gift City etc. Such a step would help to list the investment vehicle in the local stock market or to explore other such strategic opportunities involving the fund vehicle.
 - d. Lastly, from a wealth preservation and security perspective, foreign investors may select pooling jurisdictions that may have in addition to tax advantage, a

⁴¹GAAR are a set of rules to ensure that assesseees do not resort to tax avoidance/ evasion by setting up complicated structures and practices that do not have any genuine business purpose. GAAR has been briefly explained in Chapter 16 of this workbook. GAAR came into effect from April 1, 2017.

political system, legal framework and enforcement and a stable currency that provide adequate protection for their wealth.

- e. Jurisdictional selection should also be based on 'equivalent jurisdiction' as per the local anti-money laundering law (AML) and combating the financing of terrorism (CFT) law. Many countries have passed such laws based on standards developed by the Financial Action Task Force (FATF). The FATF is an inter-governmental international agency to keep oversight on international money laundering and terror financing. Based on the laws created by respective countries, each country would create a list of equivalent jurisdictions that comply with acceptable FATF standards. In international investing, selecting a FATF compliant jurisdiction has become a necessity.

5.3 Anatomy of AIF Constitution

As discussed earlier, there are primarily three constitutional options to incorporate the AIF pool. Let us examine the three alternatives of a trust, LLP and company in some detail:

1. **Alternative 1 – Trust Structure** – Incorporation of a private trust to house the AIF pool is the most preferred option for a domestic fund structure. A trust is incorporated under the Indian Trusts Act, 1882. Under the SEBI (AIF) Regulations, a body corporate set up under an Act of Parliament or State Legislature is also included for this purpose. Apart from tax benefits which are enumerated in a subsequent Chapter, the Indian Trusts Act offers the management team the ability to incorporate specific terms of governance for an AIF which is set up as a trust, as may be agreed between the manager and the investors of the AIF. Though the trust is a registered body, it does not have the ability to sue or be sued like other legal entities. It is represented by its trustee, which is primarily entitled to sue or be sued for and on behalf of the trust.

The Indian Trusts Act allows different kinds of trusts. Primarily, a trust can be set up as a private trust or a public trust. Private trusts are set up to administer family properties and inheritance requirements. Public trusts are set up for a wider purpose of serving the general public usually with a charitable service motive. Trusts can also be revocable or irrevocable by the settlor, i.e. the trust property can be reverted back to the settlor if it is revocable. In an irrevocable trust, the ownership of the property is permanently vested with the trust. Further, trusts can also be 'determinate' or 'indeterminate' trusts. In a determinate trust, the share of each beneficiary is clearly demarcated. In an indeterminate trust, such demarcation is not present and the

trustee may operate the trust and allocate its benefits to the beneficiaries in a way he determines fit.

For AIF purposes, 'irrevocably settled, determinate trust' is considered more appropriate primarily from a clear tax treatment perspective. The word 'determinate' implies that the share of each beneficiary is determinable distinctly. To achieve 'determinacy', the AIF needs to ensure that its investors and their respective beneficial interests are ascertainable as per the terms of the 'indenture of trust' or the 'trust deed' setting up the AIF as a trust, at all times during its existence. This is the reason why the corpus is divided into unit capital and investors are allotted specific number of units representing their determinate share in the trust corpus or a specific scheme.

2. **Alternative 2 – LLP Structure** – A limited liability partnership (LLP) firm incorporated under the Limited Liability Partnership Act, 2008 to house the AIF pool provides a legal entity status with limited liability distinct from that of individual partners. An LLP is liable to the full extent of its assets but liability of the partners is limited to their agreed contribution in the LLP. Since liability of the partners is limited to their agreed contribution in the LLP, it contains elements of both a corporate structure as well as a partnership firm structure. There is no personal liability of a partner except in the case of a fraud. Moreover, a partner is not responsible or liable for another partner's misconduct or negligence as there is no joint and separate liability in the case of LLP as in the case of a normal partnership. The relationship between partners is governed by the LLP agreement.

The investors become the financing partners who provide capital contribution to the firm's corpus and the investment managers become the managing partners who manage the firm's capital corpus. The AIF regulations use the term 'designated partner' which is not explicitly defined. On a plain reading, it may be understood to mean a person responsible and liable in respect of the conduct and compliances stipulated for the LLP.

The LLP structure is most popular in foreign countries for AIF management. In India the AIF Regulations allow an LLP structure for an AIF and the tax law also provides for treating an LLP as a taxable entity. However, the downside is that an LLP structure demands higher compliance requirements as compared to a trust. All investors become partners which makes their entry and exit a cumbersome process under the LLP deed and needs to be updated on Ministry of corporate affairs (MCA) website. Secondly, as LLPs are also regulated by the Ministry of Corporate Affairs, the details

of investors come under public domain. The secrecy which is maintained under Trust level is lost under LLP/company level.

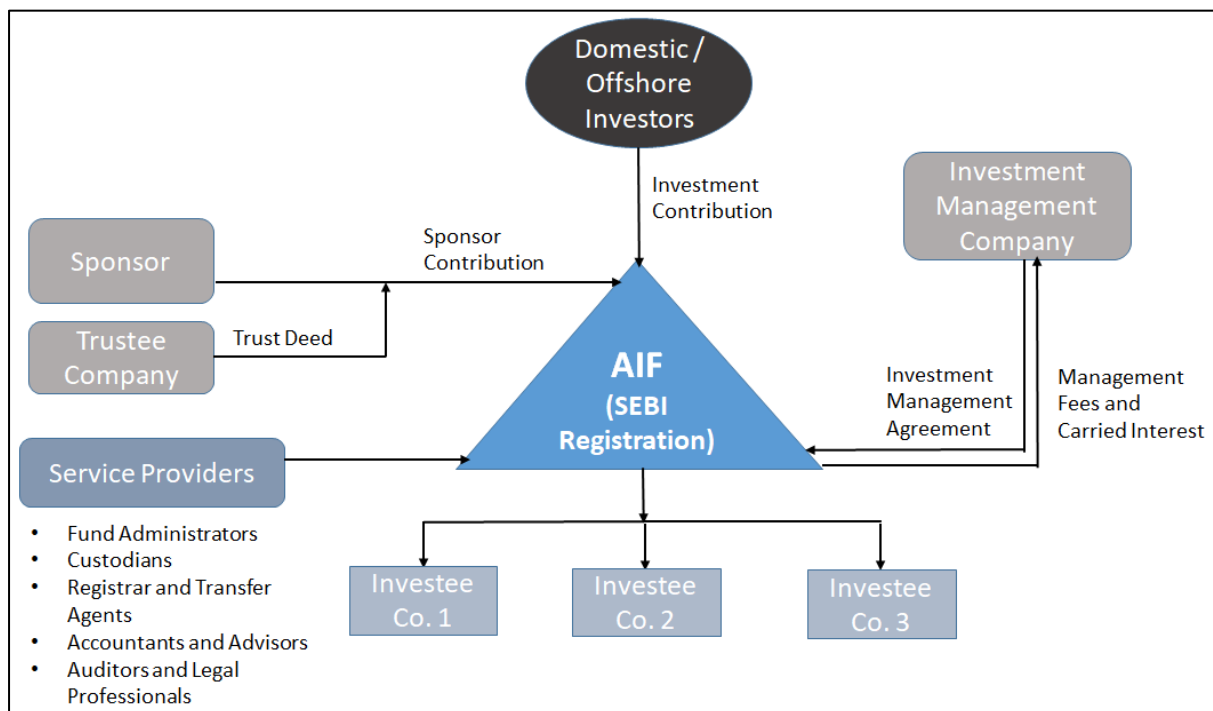
3. **Alternative 3 – Company Structure** – A company incorporated under the Companies Act, 2013 is the third alternative to house the AIF corpus. This is the least preferred alternative due to its cumbersome management and compliance requirements. Companies are subject to numerous governance and compliance requirements under the Companies Act, especially if there are public limited companies. Companies are also restricted in making private placements to not more than 200 investors though the AIF regulations permit the fund or a scheme to have up to 1000 investors.

Majority of AIFs, formed in India, follow the trust structure because of its operational advantages and favourable regulatory framework. It reduces the cost of compliance and provides flexibility for the AIF to form its own system of governance and reporting. In addition, trust structure allows for bespoke investment arrangements between investment managers and the beneficiaries which prove advantageous in attracting private capital.

5.4 Common Fund structures of AIF

As per the SEBI (Alternative Investment Funds) Regulations, an AIF can be registered as a Trust or a Company or a Limited Liability Partnership (LLP) or a Body Corporate. Figure 5.1 shows the AIF structure.

Figure 5.1: Fund Structure of an AIF



As seen in Figure 5.1 above, the AIF is formed by a Sponsor, with a minimum contribution and adequate skin-in-the-game.⁴² The Sponsor appoints the Trustee by signing the Trust Deed and the Manager by signing the Investment Management Agreement, to form part of the AIF. If the AIF is formed as a Trust, the Sponsor appoints a Trust Settlor. The Settlor could be the Fund Sponsor, Manager or a third party. Once the Fund is formed, it applies for registration with SEBI through a Merchant Banker and seeks for capital commitments from investors, domestic or foreign investors. After receiving the investment contribution and identifying suitable investments for the fund, the Fund can invest directly in the investee companies.

The Manager or Sponsor appoints the service providers, such as: Custodian for the purpose of safekeeping the securities on behalf of the investors, Fund Administrator for maintenance of accounts and investor reporting, Registrar and Transfer Agents for recording the buying and selling of units of the funds by investors, other professionals, such as Auditors, Tax Advisors, Legal Professionals, Registered Valuers and Investment Advisors etc.

In a limited liability partnership structure (LLP), the sponsor of the fund is the Designated Partner and is responsible in respect of all statutory compliances stipulated for the LLP. In most of the foreign jurisdictions, the manager of the fund is known as the General Partner (GP), while the investors subscribing to units in the fund are known as Limited Partners (LPs).

5.4.1. Off-shore and On-shore Funds

A suitable jurisdiction for setting up a fund should primarily allow tax neutrality to the investors. 'Tax Neutrality' ensures investors are not subject to any higher taxes than if they were to invest directly.

Offshore Funds and Investors: India follows source-based taxation on capital gains. Accordingly, offshore fund structures are used for offshore investors to invest into India to avoid double taxation on the same income stream. Offshore Funds are formed in countries which have Bilateral Investment Promotion and Protection Agreements (BIPA) with India. This provides offshore investors an access to several reliefs, including fair and equitable treatment, protection against expropriation, capital repatriation, an efficient dispute resolution framework and other rights and reliefs. Investments made by Offshore Funds in India are regulated by SEBI.

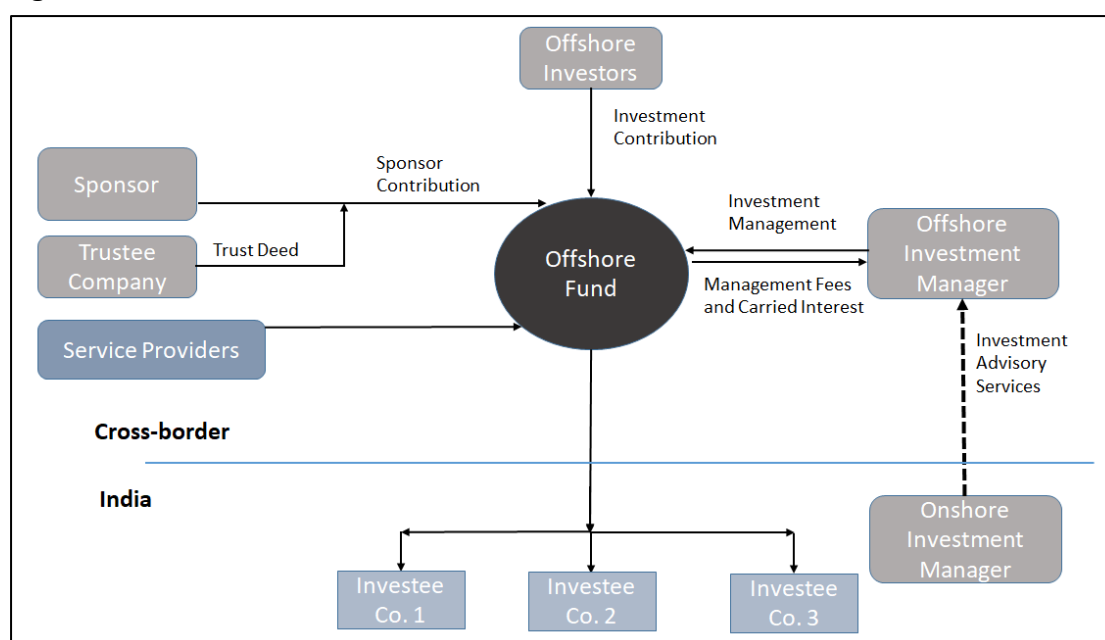
The Liberalised Remittance Scheme (LRS) issued by the Reserve Bank of India allows Indian residents to remit abroad up to USD 2,50,000 per person per financial year for any permissible current or capital account transaction or a combination of both, subject to the

⁴²Skin-in-the-game is a phrase used to ensure that the Manager also bears financial risk by investing in the AIF, along-with other investors, and managing the fund to achieve a common risk-return objective.

restrictions and conditions laid down in the Foreign Exchange Management Act, 1999 (FEMA). This limit is revised under the FEMA laws and is of importance when resident Indian investors are investing in offshore funds.

Offshore Fund Structure: An Offshore fund structure is used when there is no intent to pool capital at the domestic (i.e. India) level. Under this structure, a pooling vehicle (Offshore Fund) can be domiciled in an offshore jurisdiction, such as Mauritius or Singapore. Offshore investors will commit capital to the Offshore Fund which in turn will make investments into Indian investee companies as and when investment opportunities arise. The Offshore Investment Manager can take domestic investment advice for making such investments in India. Figure 5.2 graphically represents the offshore fund structure.

Figure 5.2: Offshore Fund Structure



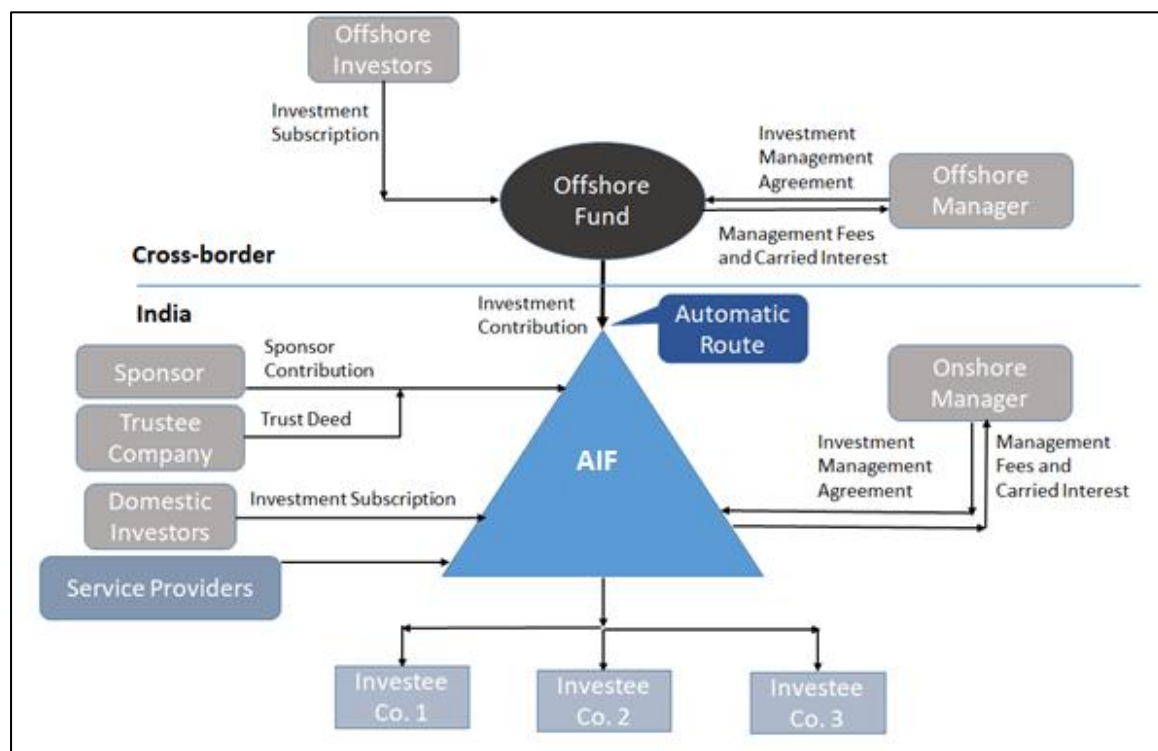
On-shore Funds: An Onshore Fund is created by a domestic Investment Manager, to pool capital at the domestic level from foreign investors and domestic investors. The Onshore Fund is domiciled in India, with capital commitments from resident investors in India as well as foreign investors. The Onshore Investment Manager will make investments into Indian investee companies, as and when investment opportunities arise.

On-shore Funds shall seek registration under SEBI (AIF) Regulations and file the PPM with SEBI through a merchant banker, in the prescribed format for their observations. Figure 5.1 depicted earlier is a typical onshore fund structure.

5.4.2 Unified and Co-Investment Structures

In a **Unified Structure**, commitments from both domestic and offshore investors are pooled into a domestic pooling vehicle (i.e. an Onshore AIF). With this structure, India-based investment management team can earn management fee and performance fees for the entire structure at the Onshore Fund level. There is no approval required from the Ministry of Finance or the RBI, for Foreign Portfolio Investors (FPI) to invest in the unified structure. General permission has been granted under the Foreign Direct Investment (FDI) Policy to accept foreign investments under the automatic route. Figure 5.3 represents the Unified Fund Structure.

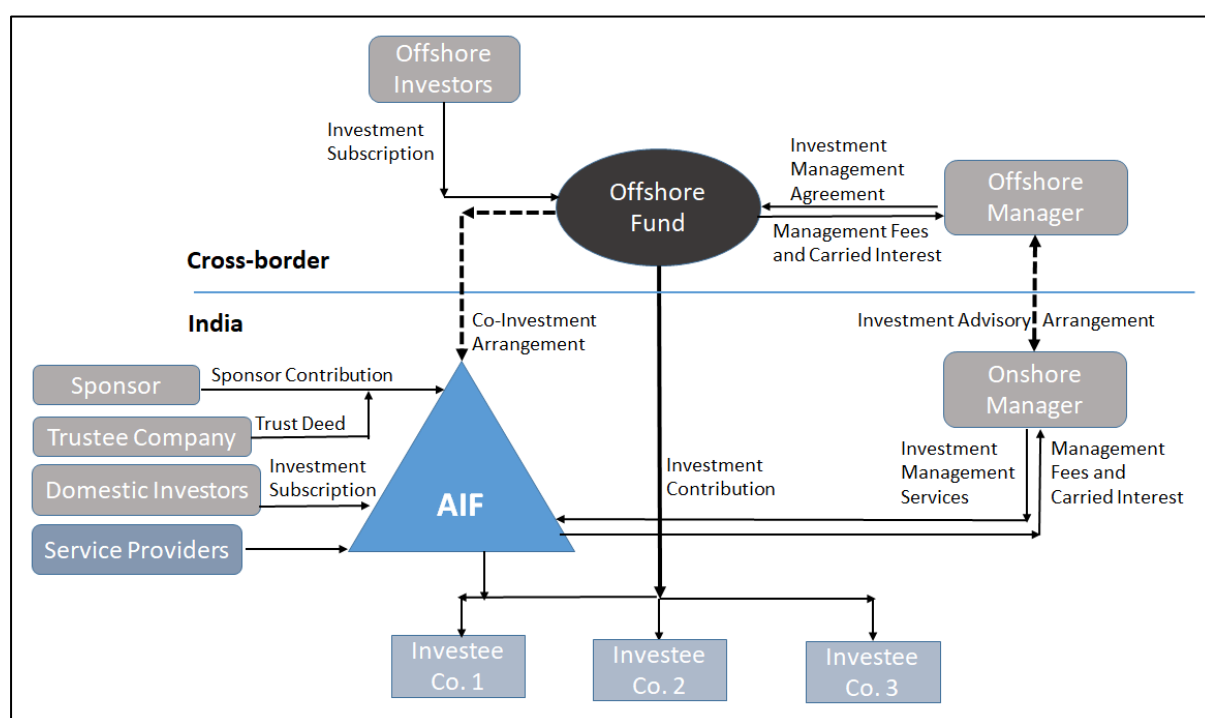
Figure 5.3: Unified Fund Structure



As seen from Figure 5.3, the Offshore Fund is located in a tax-friendly foreign jurisdiction like Singapore, Mauritius, Luxemburg, among other. The Offshore Fund then directly invests in the Onshore AIF, registered in India with SEBI. The AIF will have other domestic investors and the Offshore Fund as one of the investors. Both Funds will have their respective Investment Managers, who are paid Management Fees and Performance Fees. The Offshore Fund cannot invest in investee companies directly. The Offshore Fund can invest in an Onshore AIF, through the Automatic Route and provide the investment contribution to the fund, as per the Contribution Agreement.

In a **Co-investment structure**, the Sponsor raises capital in separate investment pools, in the domestic jurisdiction and in the foreign jurisdiction. Separate pooling vehicles are set up in India (i.e. Onshore Fund) and in an offshore jurisdiction (Offshore Fund). The Onshore Fund is managed by an India-based investment manager who enters into an Investment Advisory Arrangement with the Offshore Investment Manager, to provide recommendations on investment opportunities in the domestic market. Figure 5.4 represents the Co-investment Fund Structure.

Figure 5.4: Co-investment Fund Structure



As seen from Figure 5.4, the Offshore Fund is directly investing in investee companies or target securities of the domestic AIF, registered in India with SEBI. The Onshore Fund and the Offshore Fund both have their investors, subscribed to their units. Both Funds will have their respective Investment Managers, who are paid Management Fees and Performance Fees. The Offshore Fund has a Co-investment Arrangement with the Onshore Fund and the Offshore investment manager has the option to enter into an Investment Advisory Arrangement with the Domestic Investment Manager.

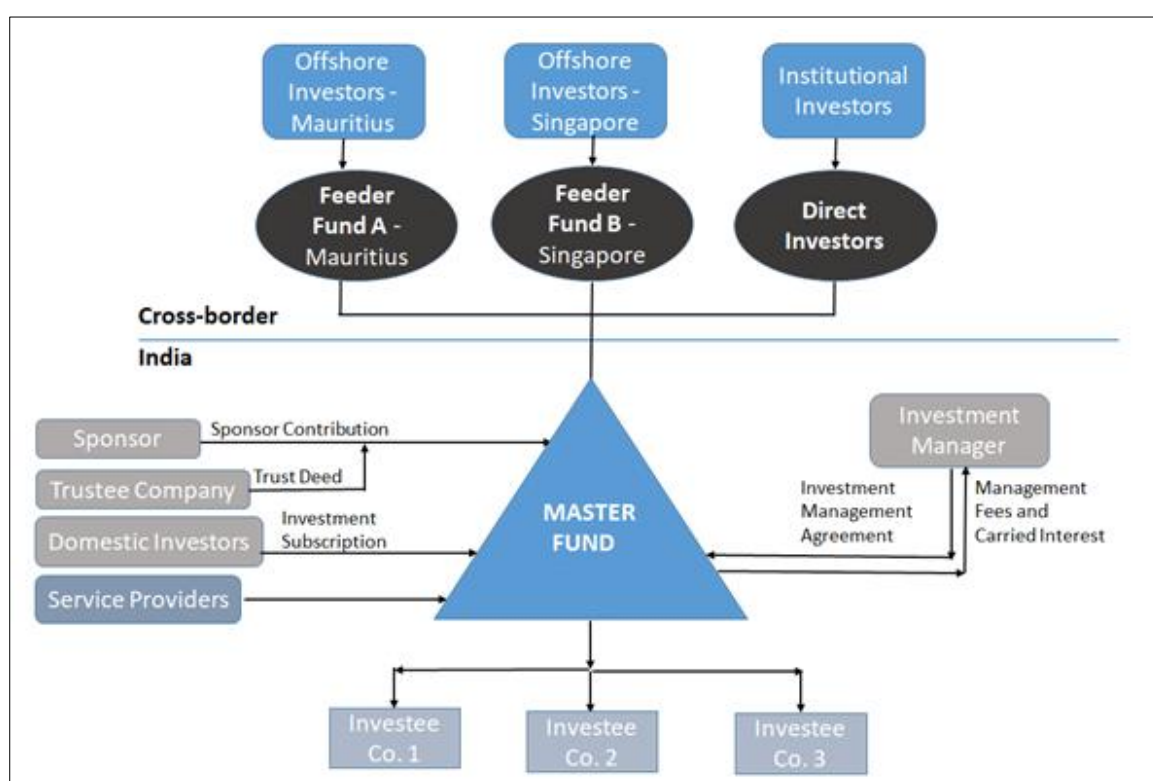
5.4.3 Master Feeder Structure and Parallel Structure

A **master-feeder structure** is a subordinated structure in which offshore investors invest through a feeder fund, which in turn invests in the domestic master fund. Direct investments

are also accepted in the Master Fund, registered in domestic jurisdiction, in this case: India. Direct investors can be domestic investors or foreign investors, in the form of Institutional Investors, High Net-worth Individuals, Banks, Insurance Companies, Pension Funds, Large Corporates, Fund of Funds and other investors. In recent years, the first International Financial Services Centre (IFSC) of India set up in GIFT City offers an offshore jurisdiction with several advantages including close proximity to the Indian market. Setting up a feeder fund in the GIFT City can help offshore investors who can directly subscribe in foreign currency into the fund. This fund can then invest in a master feeder fund set up in the domestic jurisdiction. In March 2015, SEBI issued the regulations for AIFs to be set up in the IFSC and operational guidelines were issued in November 2018.

For many investors, investing directly in a fund that is registered with SEBI in India might be tax-efficient, and regulatory-efficient. These investors are “direct investors.” However, for another group of investors, that might not be the most efficient way. To address the tax/regulatory issues specific to that group of investors, such as Mauritius and Singapore investors, the sponsor needs to set up a feeder vehicle/fund. Doing so would make investing through a feeder fund more attractive to that particular group of investors. Figure 5.5 below shows the Master Feeder Structure.

Figure 5.5: Master-Feeder Structure

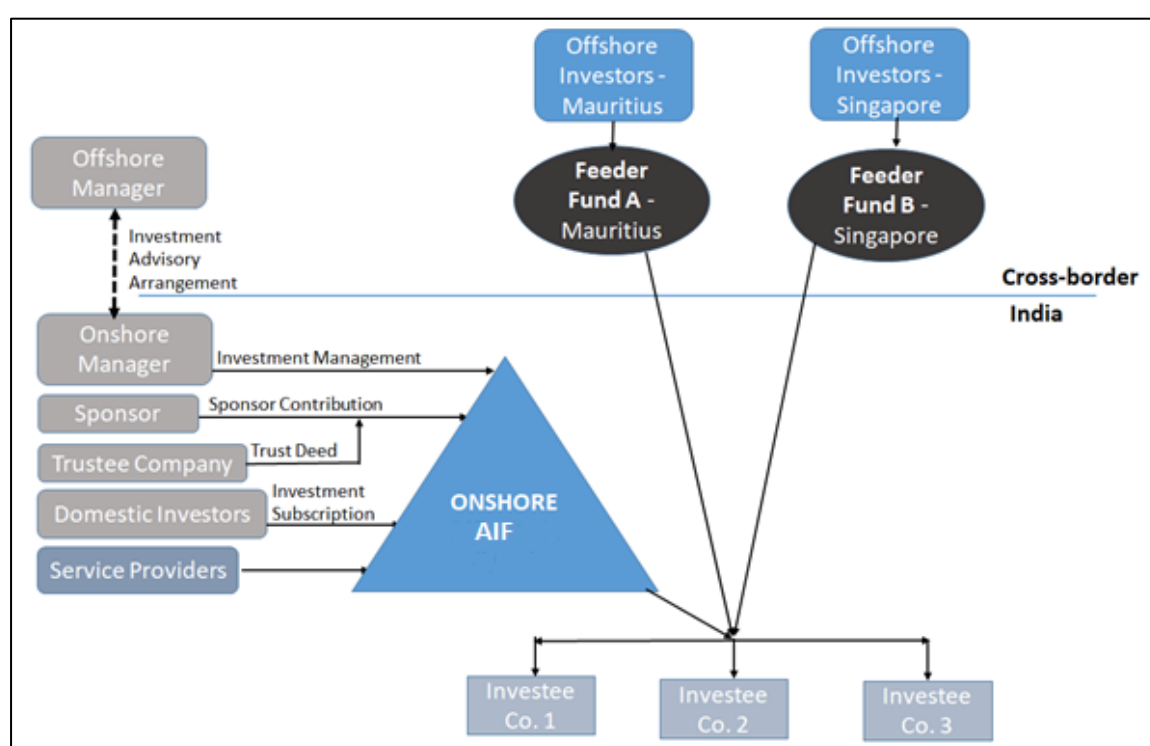


As seen in Figure 5.5 above, an Onshore Master Fund in India is attracting investments through Feeder Funds established in Mauritius and Singapore, in addition to its direct investors. Management fees typically are charged at the master fund level. At the feeder

fund level, usually only a symbolic fixed absolute amount (e.g., USD 1000) is charged. The main expense for the management fee charged to the master fund is passed on to the feeder fund through the net asset value (NAV) allocated to the relevant feeder by the master fund.

Parallel Structure: A parallel structure is a fund structure in which offshore investors invest through separate feeder fund(s) in each jurisdiction. These Feeder Funds then invest directly in the investee companies, based on their investment criteria, instead of investing in the Master Fund. Through a parallel structure, high net-worth individuals and institutional investors can also invest in the investee companies, through the Feeder Funds. Therefore, large investors do not need to allocate funds to a registered AIF in India, like in a Master-feeder structure. Figure 5.6 represents the Parallel Structure.

Figure 5.6: Parallel Structure



As seen in Figure 5.6 above, the Feeder Funds in Mauritius and Singapore are investing directly in investee companies in India, along-side the Onshore AIF. Since Feeder Funds make independent investment decisions, the Investment Manager of the AIF in India can provide investment advisory services to the Feeder Funds, by entering into an Investment Advisory Arrangement. Since the Investment Manager at the Feeder Fund is providing investment management services to its investors, the fee structure in a Parallel Structure of AIFs may be expensive, as compared to the Master Feeder Structure. However, using a Parallel Structure, investors can make diversified investment decisions, across jurisdictions offering tax benefits, unlike in the Master Feeder Structure.

Parallel Structures are common as different investors have different motives of investing, within the same fund. Advantages of investing through the Parallel Structure are as under:

- **Tax Reasons** – The primary advantage of Parallel Structures is the beneficial tax treatment received by investors in offshore jurisdictions, who invest through the Feeder Funds.
- **Selection of investments to be made** – The investors can independently choose which underlying investment to participate in or not to participate in. Hence, if a particular investee company is not suitable to a Feeder Fund or a Direct Investor, as per their stated investment mandate and risk-return profile, they are free to opt-out of that particular investment.
- **Sponsors also use Feeder Funds to place different categories of investors into different vehicles** - For instance, large investors paying reduced management fee might be placed in one feeder fund, while all the other investors who pay headline management fee rates are placed in a separate one.

5.5 Comparative Analysis

The below Table 5.1 provides a comparative analysis of different AIF structures.

Table 5.1: Comparative Analysis

Feature	Pure Domestic	Pure Offshore	Parallel	Unified
Pooling Vehicle	In India	Foreign jurisdiction	Both in India and abroad	Both in India and abroad (including GIFT city in India)
No. Of Pooling Vehicles	1	1	2	2
Applicable SEBI Regulations	AIF Regulations	FVCI Regulations	AIF Regulations and FVCI Regulations	AIF Regulations
Type of Investors in the Fund	Domestic investors in India	Foreign investors	Foreign and Domestic investors	Foreign and Domestic investors

Feature	Pure Domestic	Pure Offshore	Parallel	Unified
Routing of Investment	Domestic AIF invests in domestic investee companies	Foreign pooled vehicle invests into domestic investee companies directly from abroad	Both domestic AIF and foreign investors invest into domestic investee companies	Domestic AIF invests in domestic investee companies
Feeder Fund	Not applicable	Possible but not mandatory	Possible but not mandatory	Possible but not mandatory

Sample Questions: Chapter 5

1. The following is the most common structure adopted for a domestic AIF in India.

- a. Company
- b. Partnership
- c. Trust**
- d. Sole Proprietorship

2. Which of the following is the trust structure that is suitable for an AIF in India?

- a. Public charitable trust
- b. Limited liability trust
- c. Partnership trust
- d. Determinate trust**

3. In a Limited Liability Partnership (LLP) structure, the investors are _____ in the firm.

- a. creditors
- b. partners**
- c. partners in profit only
- d. partners without liability

4. In a pure offshore structure, the AIF is pooled outside India and registered in India under the SEBI (FVCI) Regulations. State whether True or False.

- a. True**
- b. False

5. In a _____ Structure, commitments from both domestic and offshore investors are pooled into a domestic pooling vehicle and no approval is required from Reserve Bank of India, to raise capital from foreign investors.

- a. Unified**
- b. Co-investment
- c. Offshore
- d. Master-feeder

CHAPTER 6: FEE STRUCTURE OF ALERNATIVE INVESTMENT FUNDS

LEARNING OBJECTIVES:

After studying this chapter, you should know about:

- Fee structure of an AIF
- Concepts of High Watermark and Catch-up

6.1 Management Fees and Other Expenses

AIF is a pooled investment vehicle, which collects capital contributions from investors to invest the pooled capital in eligible securities, as per the investment strategy of the Fund. As discussed in earlier chapter, an AIF appoints an Investment Manager, who provides fund management services using their investment knowledge, market experience and industry exposure. In return of such services, the Investment Manager charges an investment management fee to the fund, known as **Management or investment management Fees**. Management Fees are allocated to every investor on a pro-rata basis, based on their value of investment in the fund.

The Management Fees shall accrue from the date of the First Close, up to the date when the AIF is dissolved.

Management Fees in the Category I and II AIF industry are charged as a percentage of the Committed Capital, during the Commitment Period. Thereafter, it may be reduced to a percentage of only the actual invested capital, in case it is lesser than the committed capital, or as a percentage of the underlying value of the assets under management (AUM). Investors also request that the management fee after the commitment period be charged on the original amount of invested capital and not on the amounts utilised towards expenses or management fees. With Indian AIF market growing at a rapid pace, Investment Managers are looking at reducing the fixed Management Fees, between 1 percent and 1.75 percent depending on the scale of investments.

It is important to note that:

- Management Fee is fixed and paid to the Investment Manager, irrespective of any future gains or losses made by the Fund. Management Fees are paid for the fund management services provided by the Investment Manager and not for profit-generation.
- Management Fees are to be paid to the Investment Manager on a periodic basis, generally quarterly, semi-annual or yearly, as specified in the private placement memorandum issued by the fund. Management Fees are generally paid in arrears at a periodic interval like monthly or quarterly, when the Gross Net Asset Value (GNAV) of the AIF is computed.

- It should be noted that fees may vary depending on the amount the investor commits and timelines of commitment; these are usually captured as fees in different classes of units issued by the fund.

Example 6.1: Computation of Management Fees:

Fund ABC is launched on January 01, 2019. Following are the details of the Fund:

Total Capital Commitment	INR 50 crore
Gross NAV - at end of Year 1	INR 58 crore
Gross NAV - at end of Year 2	INR 65 crore
Management Fees (excl. GST @ 18%)	1.5%

Calculate the Management Fees payable by the Fund, in Year 1 and Year 2, considering the Fund ABC is structured as a Category I AIF and Management Fee is paid on Total Capital Commitments for every year.

Solution:

Fund ABC: Structured as a Category I AIF:

Management Fees for Year 1 and Year 2: Total Capital Commitment of the Fund – INR 50 crore (given)

Management Fees for both years:

1.5% * INR 50 crore	INR 75.00 lakhs
Add: GST – 18% * INR 75 lakhs	INR 13.50 lakhs
Total Management Fees Payable	INR 88.50 lakhs

Apart from Management Fees, the Investment Manager is also eligible for a share in the profits earned by the fund, on account of the investment management services provided by the Investment Manager. If the AIF earns a profit in any particular year, the Investment Manager is entitled to a fee for profit-sharing, known as **Incentive Fees or Performance Fees or Carried Interest**.

Incentive Fee is charged as a percentage of the incremental return earned by the AIF, generally between 0 and 20 percent, and is computed in accordance with the fee structure and computation methodology mentioned in the PPM. Such Incentive fees are an additional cost for the investors in the Fund and are allocated on a pro-rata basis to all investors, based on their value of investment in the fund.

The payment of additional returns and the quantum thereof could depend entirely on the credibility and track record of the sponsor/ manager, type of fund, scheme focus and size of the corpus.

Further, it is important to note that:

- Incentive fees are paid as an incentive to the Investment Manager to generate profits for the fund. This helps to align the interest of the Investment Manager with the interest of the fund and encourages the Investment Manager to seek best execution of investments for the interest of the investors in the fund.
- Incentive Fees are computed and payable to Investment Manager, after completion of the stated fund tenure. Generally, Category I or Category II AIFs could also follow a Deal-by-Deal Distribution mechanism, wherein the Incentive Fees are computed and paid after every exit from portfolio companies. After a successful exit, the Investment Manager will be eligible to receive the Incentive Fee, subject to certain clauses such as Clawback Provisions and Catch-up Rates.

For the purpose of computing Incentive fees, it is important to understand the methodology for computing “Profits” or “Incremental Return”. For this purpose, let us understand the concepts of Hurdle Rate, High-Water Mark, Clawback and Catch-up in the subsequent sections, before understanding the Computation of Incentive Fees.

Total Fees charged by the Fund primarily includes Management Fees and Performance Fees. However, due to the complex structure of AIF and day-to-day operations of the Fund, the Fund incurs the following additional expenses or fees which are indirectly borne by the investors:

- **Set-up Costs or Organizational Expenses:**

The Investment Manager will charge one-time Set-up Costs from the unit-holders as a percentage of their total capital commitments, which can go up to 1.5 percent or 2.5 percent of total capital commitments raised by the fund. The Set-up costs are incurred towards any offering costs, drafting of Private Placement Memorandum, registration and compliance costs, fees and commissions to be paid to intermediaries or professionals, increased by appropriate Goods and Service Tax (GST) rates and other applicable statutory taxes charged thereon. Such Set-up Costs can be amortized over the first 36 months (or as defined in PPM), or the entire life of the AIF, commencing from the date of First Closing of the fund. Set-up costs are allocated on a pro-rata basis to all investors, based on their value of total capital commitments in the fund.

- **Operating Expenses:** Typically, these are recurring expenses of the fund which the fund would charge to all investors as a whole and are subject to some limit like 10-50 basis points charged on the Net Asset Value or the capital commitments of the

firms, whichever is higher. This limit is yearly and includes majority of expenses which are over and above the investment management fees.

It includes -

- Statutory, legal, tax, accounting, audit, consulting, any other third-party fees and operating expenses related to the Fund and other professional fees;
- Banking, broken-deal, registration, qualification, finders and similar fees or commissions;
- Expenses in connection with meetings of the capital contributors or investors (travel, accommodation and out-of-pocket expenses of contributors will be borne by themselves);
- Expense incurred by the Fund for collection of Capital Contributions;
- Operating, legal and statutory expenses;
- Costs of financial statements and other reports (including reports to Capital Contributors);
- Communications, travel and other expenses;
- Expenses associated with maintenance of books of accounts and other records of the Fund;
- Administration, communication, advertising, promotional, operating, and transactional expenses (including bank charges) incurred by the Fund;
- Fees payable to banks, merchant banks, and any consultants for providing services to the Fund;
- Reasonable premiums for insurance for protecting the directors, partners, key personnel, officers, shareholders, employees and agents of the Trustee and Investment Manager of the Fund;
- Taxes, duties and costs incurred in acquiring, holding and selling the Fund's assets and other statutory expenses;
- Proportionate liquidation expenses of the Trust and the Fund;

- **Transaction Expenses:**

An AIF shall bear and pay all transaction expenses on actual basis only, without any limits, in relation to buying, selling or disposal of Investments. The Transaction Expenses are borne by the Fund and allocated on a pro-rata basis, across all classes of units, based on Capital Contributions or NAV:

- brokerage charges,
- depository charges,
- custodian transaction charges,
- securities transaction taxes,
- costs and charges as imposed by stock exchanges.

Trusteeship Fees, to be in accordance with the terms agreed with the Trustee in the offer letter. Typically, this is a fixed fees in the range of INR 1 lakh to 5 lakhs per year, depending on the size of the fund.

It is important for investors to identify and note the avoidable expenses being incurred by the Fund and negotiate a “Cap” or an upper limit on such expenses with the Investment Manager. Such expenses are a part of the Operational Expenses and Organization Expenses, such as:

- Trusteeship Fees
- Professional fees
- Administrative Costs, attributable to the investors
- Out-of- pocket expenses incurred by the Investment Manager
- Fees to third parties such as Custodians, Fund Administrators, Legal Advisors, Auditors, Investment Advisors, among others.

The best-case scenario for investors would be to negotiate with the Investment Manager to net-off such expenses against the Management Fees, already being paid. The management fees and additional returns (if any), need to be assessed on a periodical basis as per the terms of the investment agreement. By their nature, AIFs are illiquid and their underlying investments cannot be reliably valued until the investments are exited.

6.2 Hurdle Rate

The investors in AIF have an opportunity cost of investment, when investing in the fund. The opportunity cost is the return foregone on the next best possible investment in the market, in any asset class such as equities, fixed income securities, real estate, commodities or money market instruments. Therefore, all investors look for securities or investment funds that have higher expected returns, compared to the opportunity cost of investment.

For this purpose, every AIF Manager sets a “**Hurdle Rate**” or the minimum rate of return to be accrued to fund investors every year, or any shorter reporting period such as quarter or half-year. The return generated using the Hurdle Rate is known as “Preferred Return”, which is the portion of the total return of the fund that accrues to the investors only. The Preferred Return will not be taken into account directly, for the purpose of computation of Incentive Fees. Incentive Fees is paid to the Investment Manager on the return generated over and above such Preferred Return. The preferred return is entirely allocated to all the investors in the fund, on a pro-rata basis based on their value of investment in the fund.

In Indian market, hurdle rates in AIF industry (generally 7 percent to 12 percent per annum – INR terms) are meant to be higher than the international standards (generally 5 percent to 8 percent per annum – USD terms) as the historical average returns in the Indian stock market is estimated around 12 percent.⁴³

⁴³ BSE 10-year average return was 12%, according to Economic Times article: <https://economictimes.indiatimes.com/markets/market-moguls/track-record-dissecting-nifty-performance-over-the-last-decade/articleshow/96988977.cms?from=mdr>

The Hurdle Rate is important for the Investment Manager, as it serves as a threshold return over which the Investment Manager will be eligible to earn Performance Fees. If the Hurdle Rate is high, the Investment Manager will not be able to generate high incentive fees every year. Hence the Investment Manager will prefer to keep the Hurdle Rate low, in order to generate a higher incentive fees. Similarly, the Hurdle Rate is important for the Investors too. The Investors will prefer to keep the Hurdle Rate high, in order to generate higher accrued return from the fund. Thus, deciding on the appropriate hurdle rate for the fund is critical and involves serious negotiations between the Investment Manager and investors in the fund. The purpose of having a hurdle rate is to benchmark the expectations of the investors rather than to provide a guaranteed return (which is neither permissible nor possible).

For the purpose of computing the Preferred Return and the Incentive Fees, let us continue our example for AIF – Fund ABC.

Example 6.2: Computation of Hurdle Rate and Incentive Fees (Close-ended Fund):

Fund ABC is a close-ended AIF launched on January 01, 2022. Following are the details of the Fund:

Committed Capital	INR 50 crore
Total No. of units issued	5,00,000
Fund Tenure	5 years
Management Fees on Gross NAV at the end of year. (excl. GST @ 18%)	1.50%
Initial Set-up Cost of the Fund, incl. GST (amortized over 5 years)	INR 1.25 crore
Yearly fund expenses	INR 30 lakhs
Hurdle Rate	10%
Gross Net Asset Value (at end of Year 1)	INR 58 crore
Gross Net Asset Value (at end of Year 2)	INR 65 crore
Incentive Fees	15%

Calculate the Hurdle and Incentive Fees, for Year 1 and Year 2.

Solution:

Calculation of Hurdle and Incentive Fees:

Particulars	Amount (INR)	INR (Per Unit)
Called-up Capital	50,00,00,000	1000.000
Particulars	Year 1	Year 2

	Amount (INR)	INR (Per Unit)	Amount (INR)	INR (Per Unit)
Gross Asset Value	58,00,00,000	1160.000	65,00,00,000	1300.000
Less: Initial Set-up Cost (amortized) [1.25 crore/5]	(25,00,000)		(25,00,000)	
Less: Fund Expenses (yearly)	(30,00,000)		(30,00,000)	
Less: Management Fees (incl. GST) Y1: [1.5%*58 crore*(1.18)] Y2: [1.5%*65 crore*(1.18)]	(1,02,66,000)		(1,15,05,000)	
Net Asset Value (Pre- incentives) [A]	56,42,34,000	1128.468	63,29,95,000	1265.990
Reference Hurdle [B] Y1: [50 crore*(1.1)] Y2: [55 crore*(1.1)]	55,00,00,000	1100.000	60,50,00,000	1210.000
Amount for Calculation of Incentive Fee [C] = [A] – [B]	1,42,34,000		2,79,95,000	
Incentive Fees (Eligible) [15%*C]	21,35,100		41,99,250	

From the table above:

- Initial Set-up Cost of INR 1.25 crore is amortized over 5 years. Hence, set-up costs charged in Year 1 will be INR 25 lakh. (INR 1,25,00,000/5)
- Net Asset Value (Pre-incentives) is calculated by reducing the attributable set-up costs, fund expenses and Management Fees, including GST payable thereon.
- Reference Hurdle Return is computed using the Called-up Capital at the beginning of the Year and adding the minimum hurdle rate of return on the capital.
- Amount for calculation of Incentive Fee is the difference between the Net Asset Value (For distribution) and the Reference Hurdle. Such calculation is done as the Incentive Fee is to be paid only on the return earned over and above the minimum

required return i.e. the Reference Hurdle. Hence, Incentive Fees is charged as 15% of this excess amount over the Reference Hurdle. Typically, hurdle is calculated as pre-tax hurdle.

Conclusion:

- There is a sharp increase in the Incentive Fees computed for Year 2. This is due to double computation of Incentive Fees, on the Excess Return earned in Year 1. To avoid this, Investment Managers are paid Incentive Fees only at the end of the fund tenure, or at the time of making exits from investee companies, instead of being paid Incentive Fees on a yearly basis. This also ensures that Incentive Fees is paid, after providing for future possible losses or decline in the NAV of the fund.
- The hurdle rate set by the Investment Manager is low, at 10 percent. This has also resulted in a higher pay-out of Incentive Fees to the Investment Manager.
 - If the Hurdle Rate is increased to 12 percent, the Incentive Fees drops significantly as follows:
 - Year 1 – INR 6,35,100
 - Year 2 – INR 8,69,250

6.3 High-Water Mark

As discussed above, Incentive Fees are payable to the Investment Manager as an incentive to generate profits or 'Alpha' for the AIF. However, due to inherent market risks, it is possible that the investment strategy adopted may generate a loss in any year of the fund life-cycle. For instance, a Category II AIF may generate a 20 percent return in its first year, -5 percent returns in the second year and 11 percent return in the third year.

In order to ensure alignment of interest of the Investment Manager with the AIF, and to safeguard the interest of investors in the fund, no incentive fees should be paid on losses made in any year, through-out the life cycle of the Fund. The concept of High-Water Mark is introduced for this purpose.

High-Water Mark is the highest Net Asset Value, net of operating expenses, transaction expenses and management fees, achieved by the AIF at the end of the year. If the Net Asset Value has only decreased since inception of the fund, High-Water Mark is taken as the initial subscription price of units issued by such fund.

The High-Water Mark is an important input used in addition to the Hurdle Rate, to compute the Incentive Fees payable to the Investment Manager for an AIF. High-Water Mark is generally applied to Category I and II AIF Managers at the time of making an exit from a portfolio company (applicable for Category I or II AIFs following a deal-by-deal distribution waterfall).

If the High-Water Mark of the AIF is consistently rising above the previous High-Water Mark, it denotes superior past and present performance of the fund and is a good indicator for the future estimated returns of the Fund. This is important for the Investment Manager to showcase superior fund performance to investors and prospective clients, while earning higher Incentive Fees. However, if the High-Water Mark remains unchanged in previous years, it is an indicator of poor performance.

Let us understand the importance of High-Water Mark and calculation of Incentive Fees, by continuing our example for AIF – Fund ABC.

Example 6.3: High-Water Mark and Computation of Incentive Fees:

Let us take two different scenarios for the computation of Incentive Fees, with High Water Mark:

- **Best-case Scenario** – Above-average Net Returns for the Fund, above 12 percent p.a.
- **Worst-case Scenario** – Average Net Returns for the Fund, less than 12 percent p.a.

Fund ABC is a Category I AIF launched on January 01, 2023. Following are the details of the Fund:

Committed Capital	INR 50 crore
Total No. of units issued	5,00,000
Fund Tenure	5 years
Management Fees (excl. GST @ 18%)	1.50%
Initial Set-up Cost of the Fund, incl. GST (amortized over 5 years)	INR 1.25 crore
Yearly fund expenses	INR 30 lakhs
Hurdle Rate	10%

Particulars	Best Case Scenario	Worst Case Scenario
Gross Asset Value (at end of Year 1)	INR 58 crore	INR 55 crore
Gross Asset Value (at end of Year 2)	INR 65 crore	INR 54 crore
Incentive Fees	15%	15%

Calculate the High-Water Mark, Reference Hurdle and the Incentive Fees payable by the Fund, in Year 1 and Year 2.

Solution:

Best Case Scenario: Calculation of High-Water Mark and Incentive Fees

Particulars	Amount (INR)	INR (Per Unit)
Called-up Capital	50,00,00,000	1000.000

Particulars	Year 1		Year 2	
	Amount (INR)	(Per Unit)	Amount (INR)	(Per Unit)
Gross Asset Value	58,00,00,000	1160.000	65,00,00,000	1300.000
Less: Initial Set-up Cost (amortized)	(25,00,000)		(25,00,000)	
Less: Fund Expenses	(30,00,000)		(30,00,000)	
Less: Management Fees (incl. GST)	(1,02,66,000)		(1,15,05,000)	
Net Asset Value (Pre-incentives) [A]	56,42,34,000	1128.468	63,29,95,000	1265.990
High Water Mark [B]	50,00,00,000	1000.000	56,42,34,000	1128.468
Reference Hurdle [C]	55,00,00,000		60,50,00,000	
Minimum NAV eligible for Incentives [D] (Higher of [B] and [C])	55,00,00,000	1100.000	60,50,00,000	1210.000
Amount for Calculation of Incentive Fee [E] = [A-D]	1,42,34,000		2,79,95,000	
Incentive Fees (15%) * [E]	21,35,100		41,99,250	

From the table above:

- High-Water Mark for the first year is the initial subscription amount. For the second year, High Water Mark denotes the highest Net Asset Value (Pre-incentives) achieved by the Fund at the beginning of Year 2, which is INR 56,42,34,000.
- For the purpose of computing Incentive Fees, it is important to ascertain the minimum NAV eligible for an Incentive Fee, which is higher of Reference Hurdle and the High-Water Mark. If the difference between the NAV (Pre-incentives) and such minimum NAV is positive, then the Investment Manager is eligible for an Incentive Fees at the given rate of 15 percent. Incentive Fees are computed on the difference between the NAV (Pre-incentives) and such minimum NAV. If the difference between

the NAV (Pre-incentives) and such minimum NAV is negative, then the Investment Manager shall not be eligible for any Incentive Fees.

- Incentive Fees are paid regularly, in case of an open-ended Category III AIF, hence the High-Water Mark adds another threshold to be met by the Investment Manager. By taking the higher of both the amounts, viz. High-Water Mark and Reference Hurdle, it can be verified if the Investment Manager has achieved the Reference Hurdle for investors as well as added value for them, by increasing Net Asset Value of the Fund.

Worst Case Scenario: Calculation of High-Water Mark and Incentive Fees

Particulars	Amount (INR)	INR (Per Unit)
Called-up Capital	50,00,00,000	1000.000

Particulars	Year 1		Year 2	
	Amount (INR)	(Per Unit)	Amount (INR)	(Per Unit)
Gross Asset Value	55,00,00,000	1100.000	54,00,00,000	1080.000
Less: Initial Set-up Cost (amortized)	(25,00,000)		(25,00,000)	
Less: Fund Expenses	(30,00,000)		(30,00,000)	
Less: Management Fees (incl. GST)				
Y1: [1.5%*55 crore*(1.18)]				
Y2: [1.5%*54 crore*(1.18)]	(97,35,000)		(95,58,000)	
Net Asset Value (Pre-incentives) [A]	53,47,65,000	1069.530	52,49,42,000	1049.884
High Water Mark [B]	50,00,00,000		53,47,65,000	
Reference Hurdle [C]				
Y1: [50 crore*(1.1)]				
Y2: [55 crore*(1.1)]	55,00,00,000		60,50,00,000	
Minimum NAV eligible for Incentives [D] (Higher of [B] and [C])	55,00,00,000	1100.000	60,50,00,000	1210.000

Amount for Calculation of Incentive Fee [E] = [A-D]	NOT ELIGIBLE		NOT ELIGIBLE	
Incentive Fees (15%)*[E]	NA		NA	

From the table above:

- High-Water Mark for the first year is the initial subscription amount per unit. For the second year, High-Water Mark denotes the highest Net Asset Value (Pre-incentives) achieved by the Fund at the beginning of Year 2, which is INR 53,47,65,000.
- It is observed that the NAV (Pre-incentives) is higher than the High-Water Mark, but lower than the Reference Hurdle. Since the NAV has not crossed the Reference Hurdle, the Investment Manager is NOT eligible for any Incentive Fees.

Conclusion:

- In Year 2 of the Worst-case Scenario, the Net Asset Value of the Fund was below the High-Water Mark, due to which the Investment Manager was ineligible for Incentive Fees. In such cases, if investors have not negotiated a Hurdle Rate at the time of subscription, the High-Water Mark prevents undue Incentives Fees being payable to Investment Manager and serves as an additional threshold.
- There is a sharp decrease in the Incentive Fees payable to the Investment Manager, when comparing the fund performance in the Best-case Scenario and the Worst-case Scenario. Total Incentive Fees payable in 2 years was INR 63,34,350 in the best-case scenario, as compared to Zero Incentive Fees in the worst-case scenario. This highlights the importance of High-Water Marks and Hurdle Rates as key thresholds.

6.3.1 Catch-up

‘Catch-up Rate’ is the rate at which residual profits, after returning investors’ capital and hurdle, will be distributed to the Manager in order to ‘catch-up’ to and receive the pre-determined share of the ‘total profits’ of the fund, as indicated in the Performance Fees rate (generally 10-20%).

With a catch-up provision in a Deal-by-Deal Distribution, the Manager of a Category I AIF or Category II AIF receives a larger share in the profit distribution, after the investors’ capital and hurdle return is paid. Hence, as a manager, it is advisable to have a high catch-up rate, above the pre-determined rate of 10-20%, as a higher proportion of the residual profits will be allocated to the manager.

Distribution proceeds consist of amounts realized from investments made by the AIF utilising the corpus created from contributions received from investors. Realisations are both periodic during the life of the fund as well as at the termination of the fund, as and when investments made are exited. A typical deal-by-deal distribution waterfall followed by close-ended Category I AIF or a Category II AIF is in the following order:

Table 6.1 – Illustrative Deal-by-Deal Distribution Waterfall

Priority Sequence	Description
1. Expenses, taxes and statutory payments	Expenses chargeable to the fund, Income tax on investment gains, GST and other statutory dues payable from time to time.
2. Reserves	The investment manager may decide to retain some proceeds to create reserves for meeting future liabilities entirely at its discretion. Such terms would be mentioned in the PPM.
3. Management Fees and other costs	The management fees of the investment manager as well as other costs chargeable to the fund.
4. Net Proceeds	If the fund has different classes of units, there may be priority in payment inter-se among such classes. Such details would be mentioned in the PPM. For example, investors from the First Close may have priority over investors from subsequent closes. In general terms, net proceeds are to be applied first to repay corpus contributions of investors of a particular class on a pro-rata basis and then towards preferred return as per the terms of the contribution agreement with each class / investor.
5. Additional Returns / Incentives / Carry with Catch Up	If the manager is entitled to incentive fees or carry with a catch up clause, the catch up gets paid at this stage so that it equates them to the agreed share on the total return of the scheme / fund.
6. Residual distribution	This is distributed in the ratio of sharing between investors and managers holding carry. In case there is no catch up clause in the investment agreement, step (5) above is skipped and residual proceeds are shared after step (4).

Managers may prefer to include the catch-up clause in the Contribution Agreement, with a catch-up rate of 100 percent. This signifies that all residual profits in the fund, after returning investors' capital and hurdle, will be distributed to the Manager till the manager receives the pre-determined share of the total profits. Similarly, if the catch-up rate is 40%, then 40% of the residual profits in the fund, after returning investors' capital and hurdle, will be

distributed to the Manager till the manager receives the pre-determined share of the total profits. High Catch-up Rates are preferred by the investment manager of an AIF.

If the Manager chooses not to include the catch-up clause in the Contribution Agreement, then all residual profits in the fund, after returning investors' capital and hurdle, is distributed amongst the manager and the investors as per the pre-determined share of the profits. In the event of limited profits, in excess of the hurdle return, the manager may not be able to receive the pre-determined share of the total profits.

Let us understand the impact of a catch-up provision for a Manager and investors in the Fund.

Example 6.4:

XYZ Fund was launched on April 01, 2022. Following are the details of the fund:

Committed Capital	INR 50 crore
Fund Tenure	3 years
Net Asset Value (at end of Year 3)	INR 70 crore
Hurdle Rate	10%
Incentive Fees	20% of Total Profits

Compute the amount distributed to the Manager of the Fund and investors, at end of Year 3, in the following scenarios:

- a. No Catch-up Clause
- b. Catch-up Rate of 100%

Solution:

Total Profit of ABC Fund: Difference of Net Asset Value at end of Year 3 and Committed Capital

INR 70 crore – INR 50 crore = **INR 20 crore**

Pre-determined Profit Share of the Manager: As per the Incentive Fees rate, the Manager is entitled to receive 20% of the Total Profits:

INR 20 crore * 20% = **INR 4 crore**

Hurdle Return for 3 years: 10% return yearly, for 3 years of the Fund Tenure

$[\text{INR } 50 \text{ crore} * (1.10)^3] - \text{INR } 50 \text{ crore} = \text{INR } 16.55 \text{ crore}$

a. Scenario: No Catch-up Clause

- i. Distribution of Capital and Hurdle Return: Investors receive their capital contribution and the hurdle return earned over the fund tenure

Particulars	Amount (INR)
Capital Contribution	50.00 crore
Add: Hurdle Return	16.55 crore
Total	66.55 crore

- ii. Distribution of Residual Profits: Manager and Investors share the residual profit of INR 3.45 crore (i.e. INR 20 crore – INR 16.55 crore), as per the Incentive Fees of 20%

Particulars	Basis	Amount (INR)
Manager	20% * INR 3.45 crore	0.69 crore
Investors	80% * INR 3.45 crore	2.76 crore
Total		3.45 crore

Total Distribution:

Particulars	Amount (INR)
Manager	0.69 crore
Investors (INR 66.55 crore + INR 2.76 crore)	69.31 crore
Total	70.00 crore

b. Scenario: Catch-up Rate of 100%

- i. Distribution of Capital and Hurdle Return: Investors receive their capital contribution and the hurdle return earned over the fund tenure

Particulars	Amount (INR)
Capital Contribution	50.00 crore
Add: Hurdle Return	16.55 crore
Total	66.55 crore

- ii. Distribution of Catch-up Rate: Manager will receive 100% of the residual profit of INR 3.45 crore, till the manager is paid the total pre-determined profit share in total profits of the fund, i.e. INR 4 crore. Since residual profits in Fund XYZ are insufficient to provide for profit share of the manager, the entire residual profit of INR 3.45 crore will be distributed to the Manager.

Total Distribution:

Particulars	Amount (INR)
Manager	3.45 crore
Investors	66.55 crore
Total	70.00 crore

Conclusion:

It is observed that the total distribution to the Manager is INR 69 lakhs in the first scenario and INR 3.45 crore in the second scenario. This difference in the amount distributed to the manager is solely on account of the inclusion of a catch-up clause in the Contribution Agreement.

6.3.2 Clawback

In case of a Deal-by-Deal Distribution, there is usually a clawback provision built in for safeguarding the investors. In a Clawback Provision, the Carried Interest or Performance Fees based on early successful exits can be clawed-back or recovered by the investors from the manager to offset the losses on subsequent failed investments. The losses are generally calculated after reducing the sales proceeds from the capital committed. However, the hurdle return on such capital committed is not considered for this calculation, even though Hurdle refers to the Opportunity Cost of capital for the investor.

Therefore, a clawback right entitles investors to reverse any incentive fees taken by the manager during the life of the investment to ensure that performance fees or carried interest is paid as per the pre-determined ratio, based on the total profits or losses over its life. However, this clause is only as good as the manager's ability to refund the excess return, so it is important that the manager has high credibility and a balance sheet to support. This is another reason why some funds choose to charge the performance fees only at the end of the tenure of the fund to avoid any situations related to Clawback.

6.3.3 Impact of GST/VAT or other additional levies on Fees

AIFs pay professional fees on an annual basis to multiple service providers, such as Fund Administrators, Registrars, Custodians, Auditors, Brokers, Investment Advisors and other third-party professional experts. The services provided by such external service providers are taxable on a yearly basis, at the rate of 18% currently as per Indian regulations. Apart from services of external service providers, the fund also levies GST at the rate of 18% on Management Fees and Trusteeship Fees. This impacts the cost of investments for the fund and can decrease the potential returns for investors. However, investors should consider the overall costs, including taxes, while calculating returns

Example 6.5:

Fund N was launched on April 01, 2022 in Mumbai with a total corpus of INR 98 crore. This fund makes investments in securities listed on a recognized national stock exchange. Fund Term expires on March 31, 2025.

Details of NAV and Units Issued: As on April 01, 2022

Particulars	Fund N
Committed Capital	INR 98,00,00,000
No. of units issued	9,80,000
NAV	INR 1000

Fund N pays Management Fees to the investment manager at 2% of the Gross NAV of the fund, at the beginning of the year. In addition to this, following fees are payable to external service providers, for the year ending March 31, 2023:

Particulars	Fund N
	Amount (INR)
Trusteeship Fees	73,50,000
Fund Administrator Fees	42,70,000
Custodian Fees	51,10,000
Auditor Fees	44,80,000
Legal Advisor Fees	22,40,000
Investment Advisor Fees	11,90,000

Calculate the GST payable by Fund N for the Financial Year 2022-2023.

Solution:**Calculation of Total Fees and GST Payable – Financial Year 2022-2023**

Particulars	Fund N
	Amount (INR)
Management Fees (2% of NAV, as on April 01, 2022)	1,96,00,000
Add: GST on Management Fees @ 18% [A]	35,28,000
Total Management Fees payable	2,31,28,000
Trusteeship Fees	73,50,000
Add: GST on Management Fees @ 18% [B]	13,23,000
Total Trusteeship Fees payable	86,73,000
Fund Administrator Fees	42,70,000
Add: GST on Management Fees @ 18% [C]	7,68,600
Total Fund Administrator Fees payable	50,38,600
Custodian Fees	51,10,000
Add: GST on Management Fees @ 18% [D]	9,19,800
Total Custodian Fees payable	60,29,800
Auditor Fees	44,80,000
Add: GST on Management Fees @ 18% [E]	8,06,400
Total Auditor Fees payable	52,86,400
Legal Advisor Fees	22,40,000
Add: GST on Management Fees @ 18% [F]	4,03,200
Total Legal Advisor Fees payable	26,43,200
Investment Advisor Fees	11,90,000
Add: GST on Management Fees @ 18% [G]	2,14,200
Total Investment Advisors Fees payable	14,04,200
Total GST Paid by Fund [A+B+C+D+E+F+G]	79,63,200

Particulars	Fund N
	Amount (INR)
NAV as on April 01, 2022	98,00,00,000
Total GST as a % of Committed Capital	0.81%

As seen from the table, the impact of GST can be as high as 0.81% of the Gross NAV of the fund, if GST is charged on services provided by all external service providers. Since the external service providers are providing 'financial services', GST is chargeable at 18% annually. A large outflow of fees to service providers, trustee and investment manager will result in a higher liability towards GST for the fund, which may not be recoverable in form of input credits as AIFs do not necessarily collect GST on output services, thereby increasing the indirect cost for investors in the fund.

Sample Questions: Chapter 6

1. Total Fees charged by a Category I AIF includes Management Fees and Performance Fees only. State whether True or False.

a. TRUE

b. FALSE

2. In which of the following scenarios is management fee paid to the Investment Manager of an AIF?

a. if gains are earned by the fund

b. if investors 75% investors by value vote towards payment of such fees

c. irrespective of any future gains or losses made by the Fund

3. The _____ is the threshold return over which the Investment Manager will be eligible to earn Performance Fees.

a. Hurdle Rate

b. Internal Rate of Return

c. Gross Net Asset Value

CHAPTER 7: FUND PERFORMANCE AND BENCHMARKING

LEARNING OBJECTIVES:

After studying this chapter, you should know about:

- Types of Risks (Investor level and Fund level)
- Various return metrics (Gross and Net IRR/J Curve/TVPI/DPI/RVPI/KS-PME/Direct Alpha)

Fund performance is most actively monitored by all the stakeholders of an AIF, being the investment manager, investors, sponsor, trustees, financial institutions as well as the market regulator. Return attribution plays a crucial role for the Investment Manager to get future capital contributions from new and existing investors. Historical performance and risk-return measures are used for comparison of various AIFs in the market and fund allocation. The AIF with the highest return and which outperforms the market will become the most preferred fund for future allocations. However, investors need to be cautious that historical performance does not guarantee the same return in future, as AIF investments are subject to various risks. Box 9.2 provides a brief overview on the Global Investment Performance Standards followed by AIFs worldwide.

Box 7.1: Global Investment Performance Standards (GIPS®)

Alternative Investment Funds are recommended to comply with the Global Investment Performance Standards (GIPS®), to ensure full disclosures and fair performance presentation which helps to advance fair competitive practices within the industry and meet the demands of prospective clients and investors. The GIPS are recognized as a global standard for calculating and presenting investment performance around the world.

The mission of the GIPS standards is to promote ethics and integrity in the investment management industry and to build trust within the investors, by achieving standardized performance reporting and compliance by asset owners and asset managers.

Investment Management Firms, like AIFs, should adhere to the best practices in calculation and presentation of performance, recommended by GIPS standards. AIF being a pooled investment vehicle must report the consolidated performance of all its schemes in different composites. A Composite can be defined based on investment strategy or investment objective to be followed by the schemes within the composite.

In addition to this, the GIPS require firms to adhere to certain calculation methodologies, which ensure integrity of the input data used in performance presentations, such as Gross IRR and Net IRR on pre-tax basis, Time-weighted Rate of Return, Money-weighted Rate of Return and valuation methodologies of underlying portfolio holdings of the fund. Such calculation methodologies enhance the comparability of investment performance across different investment firms.

An AIF should present annual investment performance, compliant with the GIPS, for a minimum period of five years, or since the inception of the fund. Prospectively, the AIF must present an additional year of performance each year, building up to a minimum of 10 years of GIPS-compliant performance.

I. Risk Metrics:

7.1 Risks in AIF

When an AIF issues a PPM to investors, seeking capital commitments, there are different types of risks associated with such investments. All risks can be either at the investor level or at the fund level. Investor level risks are prevalent both for equity and pure debt funds. At the fund level as well, there are risks that could mainly relate to external factors, governance, government policy, regulatory and tax framework. The types of risks that are inherent therein are listed in detail in the Annexure 9.1 to this Chapter. The fundamental factors creating risk environment for AIF investors are discussed below.

7.1.1 Investor Level Risks

- 1. Risk of Adverse Selection** – Choosing the right fund manager is a difficult task for investors. Fund PPMs sometimes make forward looking statements or show a manager track record that may not be an assurance of future performance. The risk of adverse selection of a manager would mean either sub-optimal returns or moral hazards for investors.
- 2. Illiquidity and Uncertainty** – Under the AIF Regulations, Category I and II AIFs need to be close ended funds because such investments are primarily illiquid. Illiquidity refers to the inability of the fund to sell its investments reasonably at proper exit valuations within the life cycle of the fund. In the case of AIF investments, illiquidity can be especially severe when a fund has remaining capital calls or when an investor attempts to liquidate a position before its termination. Sometimes investors may not be able to exit the fund till winding up and distributions are completed in full. In times of market stress, the fund would also find it difficult to make exits from its investment at optimal value. Similarly, when fund cycle does not permit extensions, exits may be ill-timed or under-valued.
- 3. Fund Monitoring** - Lack of proper investment opportunities may sometimes curtail fund performance. Nevertheless, monitoring is advisable, and investors can play valuable roles in working with fund managers, by being a part of the Investment Management Committee. Large ticket-size investors and Accredited Investors have

been given the right of representation on the Investment Management Committee, in order to monitor investment opportunities and the underlying risks.

- 4. Cash Management** - Uncertain capital calls and uncertain exits (with regard to both size and timing) raise substantial cash management issues for AIF investors, especially if the commitment period and exit period is not defined clearly in the PPM. In such cases, it is unclear when the committed capital will be called and how much cash will be generated in the interim in the form of distributions from previous investments. Hence it may become difficult for an investor to predict and control the cash flow. An institutional investor that sets aside large amounts of cash to meet potential calls runs the risk of diluting performance by compromising returns due to idle cash. Institutional investors often pursue an over-commitment strategy in which forecasted capital calls on outstanding commitments exceed current cash balances.
- 5. Underlying Investment Risks** – Like in any investment activity, when an AIF invests its capital in underlying investee companies, it takes a variety of investment risks as well as business risks of investee companies. These could relate to a variety of areas such as policy and regulatory risks, state of economy, financial markets, interest rates, foreign exchange risks for offshore investors, reliance on service providers, industry risks of a sector, governance risks in investee companies, litigation, tax law inconsistency etc. In Category I AIFs, investments are made early due to which, they could be the risk of adverse selection, infant mortality and lack of step-up in value. Category II AIFs may make some investments in listed equity and debt which are subject to capital market risks. The fund makes its returns based on appreciation in the value of underlying investee companies which can be affected by any of the above risks.
- 6. Debt Financing Related Risks** – Many Category I AIF and Category II AIF investments could be in debt securities and financings include pure debt funds and special situation funds that address stressed company financings, Leveraged Buyouts, among others. Debt financing is subject to credit risk which would consist mainly of interest rate risk and default risk. Some debt funds are sectoral funds for assets in real estate and infrastructure sectors which could have long gestation and other project risks along with cash flow problems. There could be risk in recovery of interest as well as capital in such investments arising from default, illiquidity and debt resolution process.

7.1.2 Governance/ Fund Level Risks

Based on the inherent factors due to which risk arises in AIF investments as discussed above, the fund level risks that investors need to bear in mind are briefly listed below. These are a

part of the risk factors that investors assume which are distinct from the underlying risks faced by investee companies that are automatically subsumed by the fund due to its exposure to them. The Fund level risks are broadly categorised as follows:

1. The risks associated with fund structure and governance form the most important part of fund level risks, widely known as Fiduciary duty. Since the fund is governed with a structure that places reliance on the trustee, manager, other decision-making committees and services of outside service providers like valuation agencies and auditors, the competence, integrity and standards of governance exhibited by these participants are crucial to fund performance. The lack of transparency in fund matters and reporting, related party transactions or unethical practices in fund governance can pose immense moral hazards.
2. Fund management related risks are the next important category of fund level risks. The ability of managers to find quality investments, concentration risks arising from sectoral exposures to particular types of businesses, sub-optimal structuring of investment contracts with investee companies, the quality of investment management thereof, sub-optimal exits from investee companies etc. are typical of investment management risks that the scheme / fund is exposed to at the entity level.
3. Macro-level and general risks such as regulatory risks, currency risks, economic factors, changes in tax provisions etc. form the third category of fund level risks that can affect fund performance. Some of these changes could be adverse on fund returns. For e.g. a significant currency depreciation could impact the returns of foreign AIF investors when they repatriate the proceeds in foreign currency. Similarly, a slowdown in the general economy could impact businesses of underlying investee companies. This may have an adverse effect on fund valuations and exits that would in turn adversely affect investor returns.

7.2 Types of Risks in AIFs

1. **Performance Risk:** Risks associated with the investment structure adopted by the AIF. Performance Risk covers the following risk factors:
 - **Potential Loss of Investment:** Prospective Investors should be aware that the value of the units of the Fund and the return derived from them may fluctuate. The same applies to the assets in which the Fund will invest. In addition, there can be no assurance that the Fund will achieve its Investment Objective. As is true of any investment, there is a risk that an investment in the Fund will be lost entirely or in

part. The Fund is not a complete investment program and should represent only a portion of an investor's portfolio management strategy.

Investment Managers deploy a fundamental, research-intensive approach to investing. The risk of such a fundamental analysis is that it may not always result in a profitable outcome because the Investment Manager may not know all of the factors affecting a particular investment.

- **Investment Strategy:** If the Investment Strategy is speculative, the Investment Manager may seek movements in the price level or volatility of individual investments, market segments and the financial markets as a whole. Successful implementation of this strategy requires accurate assessments of general economic conditions, industry analysis, prospects of individual companies and future behaviour of other market participants. The direction of the financial markets is often driven by unforeseeable economic, political and other events and the reaction of market participants to these events.

If there is a change in the Investment Strategy of the AIF, the Investment Manager may change the allocation of assets within the fund with greater risks. An investment in an AIF entails a high degree of uncertainty and risk.

- **Unsuccessful First Close:** If the Investment Manager is not able to achieve First Close within 12 months from the date of SEBI intimation, the AIF will have to file for a fresh application for launch. This may delay the deployment of funds by the Investment Manager, especially during favourable market conditions and economic cycles.
- **Dependence on Investment Manager:** Investors subscribing to units of an AIF have limited rights to participate in the management of the fund and making investment decisions. Consequently, they must rely on the Investment Manager with respect to the management and investment decisions of the Fund. If the Investment Manager cannot continue to manage the Fund, due to bankruptcy or dissolution, the Fund may liquidate its assets during the winding-up process, as per the SEBI circulars on Liquidation Schemes. Further, if members of the key investment team cease to provide their investment expertise to the Investment Manager, the quality of the investment management services provided to the Fund may be adversely affected. In such cases, it might not be possible to realize the full value of the investments.

The information available to an Investment Manager, at the time of an investment decision, may be limited, and the Investment Manager may not have access to all

the necessary information, to analyse a potential investment opportunity. Hence, no assurance can be given that the Investment Manager will have knowledge of all relevant circumstances that may adversely affect an investment. Moreover, the Investment Manager may rely upon investment advice given by independent consultants, in connection with the evaluation of proposed investments.

- **Incentive Fee:** The Investment Manager may choose to make investments that are riskier or more speculative in comparison with the investment objectives of the AIF, in order to earn higher Incentive Fees.
- **Liquidity and Realisation of Investment:** AIFs are relatively illiquid investments, as compared to investments in equity securities of listed companies. There is no secondary market for the units of the Fund. Depending on the Fund Structure, an investor may not be able to dispose-off or realise the investment in the Fund at the preferred time of exit.

Sometimes, the value of an investee company is based on future revenue growth or on favourable economic environment. If the investee company is not able to achieve the estimated revenue growth, the inherent value of the fund's investment may deplete quickly. As a result of this, the investment manager of the AIF would not be willing to, or able to sell their investment at the desired premium valuation.

- **Concentration Risk:** Although the Investment Managers of AIFs follow a general policy of diversifying the investments, the Fund may at certain times hold only a few relatively large (in relation to its capital) positions. This means that a loss in any position could have a material adverse impact on the investments of the fund. To avoid the risk of concentration, SEBI has prescribed that Category I AIFs and Category II AIFs cannot invest more than 25 percent of the AUM or investable funds in one investee company, directly or through investment in units of other Alternative Investment Funds.
- **Distribution or Repatriation of Income:** Distribution of all sources of income generated by the AIF is not guaranteed by the Investment Manager, at regular intervals. If the AIF has foreign investors, it may not be possible for the Fund to repatriate capital, dividends, interest and other income from India, or it may require government or regulatory consent or comply with legal formalities to do so. The Fund's investment may also be affected by developments relating to or restrictions under exchange control regulations.

- **Co-investments:** AIF may invest in assets through joint ventures or other co-investment structures with existing investors of the fund to add additional exposure to certain investments. Such investments may have joint and several liabilities for the investment manager, potentially impacting the fund's performance. Hence, it is crucial that the Co-investment arrangement and the Contribution Agreements are negotiated well with other Co-investors.
- **Geo-Political Risks:** Uncertainties arising from war, pandemic, threat of terrorism, on-going military including heightened security measures, international tensions and the outbreak of infectious diseases throughout the world may cause disruptions to commerce, reduced economic activity, and continued volatility in markets throughout the world. Some of the assets in the AIF's portfolio may be adversely affected by declines in the securities markets and economic activity because of these factors.

The Fund may incur significant losses in the event of disrupted markets and other extraordinary events in which historical pricing relationship, for the investments made, becomes materially distorted. The risk of loss from pricing distortions is compounded as many positions become illiquid, making it difficult to close out positions.

It is difficult to predict whether any additional interim or permanent governmental steps may be taken and what effect such steps may have on the Fund's investment strategies.

2. **Funding Risk:** Capital commitments are made by investors to the AIF manager and capital contributions are made once the capital call is made by the Investment Manager. It is possible that some investor may not honour subsequent capital calls either on account of inability or due to poor fund performance. Such events can distort the timing of cash flows for the Investment Manager and impact the expected return of the Fund.
3. **Macroeconomic Risk:** Macro-economic factors such as governmental, monetary and tax policies, domestic and international economic and political considerations, fiscal deficits, trade surpluses or deficits and other regulatory requirements may substantially impact the Net Asset Value of the AIF. Furthermore, due to interest rate changes, funds employing a hedging strategy may not be able to implement the strategy and find a perfect hedge against their risk.
4. **Foreign Exchange Risk:** Foreign exchange trading risks include, but are not limited to, exchange rate risk, interest rate risk and potential interference by the Indian regulators through regulation of local exchange markets, foreign investment, or particular transactions in foreign currency.

- 5. Operational Risk:** Operational risk is the risk of losses occurring because of inadequate systems and control, human error, or management failure. The complexity of certain investment products requires special emphasis on maintaining adequate human and systems controls to validate and monitor the transactions. The information systems or facilities used by the Fund may be susceptible to employee error or malfeasance, surveillance or other security threats.

An AIF needs to have adequate business continuity plans and disaster recovery plans for its operations, as it relies heavily on third-parties such as sub-advisors or fund administrator. Such key third parties also, in turn, need to have adequate business continuity plans and disaster recovery plans to limit any loss of data or resources.

- 6. Cyber Security Risk:** As part of business, an AIF will process, store and transmit large amounts of electronic information, including information relating to the transactions of the Fund and personal identifiable information of the investors. Similarly, service providers of the Fund will process, store and transmit such information. With the increased use of technology and artificial intelligence techniques, investment vehicles and their service providers may be prone to information security risks resulting from cyber-attacks. Cyber-attacks include stealing or corrupting data maintained online or digitally, denial-of-service attacks on websites, the unauthorized release of confidential information and causing operational disruption.

AIFs should have adequate internal procedures and systems in place to protect such information and prevent data loss and security breaches. However, such procedures cannot provide absolute security. It may be difficult to detect the techniques used to obtain unauthorized access to data.

Hardware or software acquired through third parties may contain defects in design or other problems that could unexpectedly compromise information security. Network connected services provided by third parties to the Fund may be susceptible to compromise, leading to a breach of information. Online services provided by the Fund, or any of their service providers may also be susceptible to compromise. Under existing regulations, all security market intermediaries are required to store their data in Indian geographical boundaries and should also have adequate control and checks in place as per CERT (Computer emergency response team – Unit of Meity, GOI). Any incident on the above risk needs to be reported to the sector regulator and central government within 6 hours.

- 7. Country-specific Risks:** AIFs may be adversely affected by potential political and social uncertainties in any emerging market economy.

High inflation may lead to the adoption of corrective measures designed to moderate growth, regulate prices of staples and other commodities which could inhibit economic activity in India and possibly affect the Fund.

- 8. Legal and Regulatory Risks:** Regulatory reforms in the Alternative Investments Market by SEBI, along-with related reforms by Reserve Bank of India (RBI), Ministry of Finance, Central Board of Direct Taxes (CBDT) and other regulatory authorities could significantly and/or adversely affect the value of investments made by the AIFs, in India or outside India.

Legal and Regulatory Risk covers the following risk factors:

- **Regulatory Approvals:** All AIFs require SEBI approval and get registered as a Category I AIF, Category II AIF, Category III AIF, or a Specified AIF. In addition, the Fund requires the prior approval of the Ministry of Commerce and Industry and the Reserve Bank of India to invest beyond certain specified equity ceilings in certain Indian portfolio companies.

The Sponsor of the Fund also requires certain approvals from regulatory authorities in the respective jurisdiction, such as GIFT City, India. If policy changes, announcements or regulations are made in the jurisdiction, it may adversely impact the performance of the Fund.

- **Tax Rates:** Investors in the Fund are subject to a number of risks related to tax matters. Alternative tax positions adopted by the income tax authorities could give rise to incremental tax liabilities in addition to the tax amounts already discharged by the Fund. Higher tax flows also impact future distributions to the investors, made by the Fund.
- **Compliance Risks:** With the recent developments in the Indian AIF industry, there are stringent compliance norms, whereby the Investment Manager or Sponsor need to comply with circulars issued by SEBI, such as Investor Charters, disclosing CTR reports, prudential norms, overseas investments, and other restrictions from time to time. This may affect the bandwidth of an AIF, unless the Investment Manager is well-equipped to comply with all regulatory requirements.

- 9. Reputational Risk:** If the Investment Manager of an AIF is unable to raise sufficient capital for a successful First Close or Final close, the existing investors may not wish to make further capital contributions to the fund due to lack of reputation in the market. Similarly, if the Investment Manager has delivered below-average returns and distributions to the existing investors in one fund, it can deteriorate the reputation of the Investment Manager and make it difficult for the Investment Manager to raise capital for a subsequent fund.

10. Environmental, Social and Governance (ESG) Risk: All AIFs shall mandatorily follow a Stewardship Code in relation to their investment in listed equities.⁴⁴ The Investment Manager of an AIF should ensure that they have adequate internal controls, processes and systems to ensure that the fund can successfully follow the Stewardship Code. Furthermore, the Investment Manager should ensure that the Fund makes a periodic report available to SEBI, as well as to its clients and beneficiaries, on its Stewardship activities. If the Investment Manager is not successfully following the Stewardship Code, as part of its internal process, it provides a bad signal to potential institutional clients looking to invest in the fund.

II. Return Metrics:

7.3 Return Measures in Alternative Investments

When analysing the return of an investment, investors most often use two key metrics: The Internal Rate of Return (IRR) or Financial Internal Rate of Return (FIRR) and Return on Investment (ROI). The ROI is also known as the Holding Period Return. The IRR is a powerful metric that measures investment returns which should be distinguished from the 'Economic Internal Rate of Return' (EIRR) which also consider wider direct and indirect economic benefits. ROI and IRR are complementary metrics where the main difference between the two is the time value of money. ROI gives you the total return of an investment but does not take into consideration the time value of money. IRR does take into consideration the time value of money and gives the annualised rate or periodic yields.

7.3.1 Internal Rate of Return (IRR)

Internal Rate of Rate (IRR) is the return based on timing of the cash flows generated by the AIF. IRR represents the rate of return at which the present value of the cash outflows for the investors is equal to the present value of inflows. The timing of the cash flow is important in IRR. IRR computes the time period for every investment in the fund and accordingly calculates the time-weighted return generated by such investment.

For example, a return of 15 percent generated by one investment may be over a time period of one year or three years. Certainly, investors will prefer the investment return to be generated in a shorter period of time, i.e. one year in the example.

⁴⁴ SEBI Circular No.: CIR/CFD/CMD1/168/2019 dated December 24, 2019 on Stewardship Code for all Mutual Funds and all categories of AIFs, in relation to their investment in listed equities.

IRR is especially useful when evaluating alternative investments since they are illiquid, the funds are close ended, cash flow is uncertain and distributions may happen during its life and on winding up. So, measuring the IRR over the life cycle of the fund with uneven cash flow gives an overall picture of the fund performance. The IRR if measured on a year-on-year basis, would also provide the trend in the growth of returns or otherwise. But depending upon the cash flow patterns of the distributions, sometimes IRR may not provide the exact picture when different investment options are compared based on their IRR. For e.g. if an investor earns an IRR of 20% in two years from an investment in traditional assets, it would be vastly different from earning 25% from an AIF with a holding period of 8 years on illiquid assets.

IRR is computed in multiple ways, such as:

Since-inception IRR: Since-inception IRR is calculated using the cash inflows and cash outflows, generated since the launch date of the fund, till the date of calculating and reporting the IRR to the investors. If the IRR is being computed for a previous fund which was liquidated, it is also known as Life-time IRR.

Gross IRR: Gross IRR is calculated with the cash inflows and cash outflows at the fund level, before deducting management fees, incentive fees, fund expenses and taxes paid. Cash outflows for investors will be total capital calls made by the fund and cash inflows will be the net distribution received from the fund, for the purpose of calculating the Gross IRR. Gross IRR calculates the Gross Return generated by the Fund, without taking into account the expenses borne by the Fund, which is indirectly allocated to the investors on a pro-rata basis.

Net IRR: Net IRR is calculated with the cash inflows and cash outflows at the investor level. Investors will calculate cash outflows such as capital commitments made for investments, management fees, incentive fees and fund expenses. Cash inflows will be calculated using the distributions made by the fund, after deducting taxes paid. Net IRR treats all fund-level expenses as the expenses borne by the investors, indirectly. Hence, Net IRR will be lower than the Gross IRR of the fund.

In contrast, the ROI measurement averages the absolute returns over the life cycle thereby ignoring the timing of the cash flow and trends in the performance. In the AIF industry, to use the ROI metric, it is necessary to understand the computation of Gross IRR and Net IRR.

Example 7.1: Gross IRR and Net IRR:

Fund ABC is a close-ended Category II AIF launched on January 01, 2019. Following are the details:⁴⁵

⁴⁵ For the purpose of this illustration, the timing of payment of capital gain tax is ignored since the timing of exits made by the fund are not considered.

Committed Capital	INR 50 crore
Total No. of units issued	5,00,000
Fund-life	5 years
Management Fees (excl. GST @ 18%)	1.5%
Initial Set-up Cost of the Fund, incl. GST (amortized over 5 years)	INR 1.25 crore
Yearly fund expenses	INR 30 lakhs
Hurdle Rate	10%
Incentive Fees	15%
Long-term Capital Gain Tax on Distributions	11.96%

The following scenarios are taken for computation of Gross IRR and Net IRR:

- **Best-case Scenario** – Above-average Net Returns for the Fund, above 12 percent p.a.
- **Worst-case Scenario**– Average Net Returns for the Fund, less than 12 percent p.a.

Particulars	Best-case Scenario	Worst-case Scenario
Gross NAV – as on December 31, 2019	INR 58 crore	INR 55 crore
Gross NAV – as on December 31, 2020	INR 65 crore	INR 54 crore
Gross NAV – as on December 31, 2021	INR 77 crore	INR 59 crore
Gross NAV – as on December 31, 2022	INR 90 crore	INR 65 crore
Gross NAV – as on December 31, 2023	INR 115 crore	INR 70 crore

Calculate the Gross IRR and Net IRR of Fund ABC. Consider the fund's accounting year to be closing in the month of December, every year.

Solution:

Best-case Scenario:

Gross IRR of the Fund is calculated using the cash inflows and cash outflows at the fund level, i.e. the Capital Calls and the Distributions made to Investors. Since it is a close ended Category II Fund, we need to compute the Distribution made at the end of Year 5. Distributions can be calculated, by deducting the yearly expenses, management fees and incentives fees of each year, as per the following table:

Calculation of Net Distribution: Best-case Scenario

(INR in thousands)

Particulars	2019	2020	2021	2022	2023
Gross Asset Value (A)	580000.00	650000.00	770000.00	900000.00	1150000.00
Initial Set-up Cost (B)	(2500.00)	(2500.00)	(2500.00)	(2500.00)	(2500.00)
Yearly Expenses (C)	(3000.00)	(3000.00)	(3000.00)	(3000.00)	(3000.00)

Particulars	2019	2020	2021	2022	2023
Management Fees (D) [1.5% * A * (1.18)]	(10266.00)	(11505.00)	(13629.00)	(15930.00)	(20355.00)
NAV (Pre-Incentives) (E) [A - B - C - D]	564234.00	632995.00	750871.00	878570.00	1124145.00
High-Water Mark (F)	500000.00	564234.00	632995.00	750871.00	878570.00
Reference Hurdle (G)	550000.00	605000.00	665500.00	732050.00	805255.00
Amount for Incentives (H) [E - (Higher of F and G)]					245575.00
Incentive Fees (I) [15% * G]					36836.25
NAV (Pre-tax) (J) [E-I]					1087308.75
Tax (K) [11.96% * (J - 50 crore)]					(70242.13)
Distribution (L) [J - K]					1017066.62

NAV (Pre-tax) is computed after deducting the Incentive Fees pay-out in Year 5. Also note that Net Distribution is made in the last year. Hence, long-term capital gain tax is paid at time of distribution @ 10%, with an additional 15% surcharge and 4% education cess. Net NAV (Post-tax) is equal to the amount of total distributions made, at the end of Year 5 of the fund.

In order to compute the Gross IRR, all cash inflows and outflows are identified. Cash outflows for the investors are the capital commitments and the only cash inflow is the Net Distribution. All other expenses will be ignored for the computation of Gross IRR. The date and amount of all cash inflows and cash outflows are mentioned in the following table:

Cash Inflows and Cash Outflows: Gross IRR for Best-case Scenario

Date	Amount (INR)
Outflows:	
01-01-2019	(50,00,00,000)
Inflows:	
31-12-2023	101,70,66,623

It is important to note that the cash outflow for January 01, 2019 is INR 50 crore, as we are computing cash outflows and not total assets. Using the above data, we can compute the IRR using the XIRR function on Microsoft Excel, or the Cash Flow function on a financial calculator, or the following formula:

$$0 = \sum_{t=1}^T \frac{C_t}{(1 + IRR)^t} - C_0$$

where:

C_t = Net cash inflow during the period t

C_0 = Total initial investment costs

IRR = The internal rate of return

t = The number of time periods

Using the above formula:

$$50,00,00,000 = \frac{101,70,66,623}{(1 + IRR)^5}$$

Solving for IRR, we get **Gross IRR = 15.26%**

Alternatively, we can use the XIRR Function on Excel: **=XIRR(values, dates, 0)**

For values, we select all the cash inflows and cash outflows. For dates, we select all the dates on which the respective cash inflow and cash outflow were made.

In order to compute the Net IRR, yearly cash inflows and outflows will include fund expenses, management fees and incentives fees. Cash outflows for the investors are the capital commitments, as well as the fund expenses, management fees and incentives fees paid. Net IRR equates the rate at which all the capital commitments, fund expenses, costs, taxes paid, management fees and incentives fees were invested to generate the Gross Asset Value of the fund, at the end of the fund life. The following table computes the cash outflows and cash inflows, for the computation of Net IRR.

Cash Inflows and Cash Outflows: Net IRR for Best-case Scenario:

(INR in thousands)

Particulars	Jan 01, 2019	Dec 31, 2019	Dec 31, 2020	Dec 31, 2021	Dec 31, 2022	Dec 31, 2023
Outflows:						
Capital Contribution	(500000)					
Initial Set-up Cost	(12500)					
Yearly Expenses		(3000)	(3000)	(3000)	(3000)	(3000.000)
Management Fees (incl. GST)		(10266)	(11505)	(13629)	(15930)	(20355.000)
Incentive Fees (2023)						(36836.250)
Tax Expense (2023)						(70242.127)

Particulars	Jan 01, 2019	Dec 31, 2019	Dec 31, 2020	Dec 31, 2021	Dec 31, 2022	Dec 31, 2023
Total Outflows:	(512500)	(13266)	(14505)	(16629)	(18930)	(130433.377)
Gross Asset Value						1150000.000
Total Inflows:						1150000.000

From the above table, it is important to note that:

- Cash Outflows in the nature of an expenditure for the investors are taken into account, such as initial set-up cost, yearly fund expenses, management fees and incentive fees.
- Timing of every cash flow is crucial. The Manager will call capital at the BEGINNING of the first year. Similarly, initial set-up cost will also be incurred at the beginning of the first year. Other outflows, such as the yearly fund expenses, management fees and GST on the fees will be paid at the end of every year.
- Incentive Fees will be paid to the Investment Manager in the last year of the fund life, i.e. at the end of 2023. Similarly, tax expenses are paid at the end of 2023.

Using the XIRR function on Excel and solving for IRR, we get **Net IRR = 12.77%**

Worst-case Scenario:

Net Distributions are calculated, by deducting the yearly expenses, management fees and incentives fees of each year, as per the following table:

Calculation of Net Distribution: Worst-case Scenario:

(INR in thousands)					
Particulars	2019	2020	2021	2022	2023
Gross NAV	550000.00	540000.00	590000.00	650000.00	700000.00
Initial Set-up Cost	(2500.00)	(2500.00)	(2500.00)	(2500.00)	(2500.00)
Yearly Expenses	(3000.00)	(3000.00)	(3000.00)	(3000.00)	(3000.00)
Management Fees (incl. GST)	(9735.00)	(9558.00)	(10443.00)	(11505.00)	(12390.00)
Net NAV (Pre-Incentives)	534765.00	524942.00	574057.00	632995.00	682110.00
High Water Mark	500000.00	534765.00	534765.00	574057.00	632995.00
Reference Hurdle	550000.00	605000.00	665500.00	732050.00	805255.00
Amount for Incentives					-

Particulars	2019	2020	2021	2022	2023
Incentive Fees					-
Net NAV (Pre-tax)					682110.00
Tax @ 11.96% (on difference of NAV over INR 50 crore)					(21780.36)
Distribution					660329.64

To compute Gross IRR, all cash inflows and outflows are identified, in the following table:

Cash Inflows and Cash Outflows: Gross IRR for Worst-case Scenario

Date	Amount (INR)
Outflows:	
01-01-2019	(50,00,00,000)
Inflows:	
31-12-2023	66,03,29,644

Using the IRR formula:

$$50,00,00,000 = \frac{66,03,29,644}{(1 + \text{IRR})^5}$$

Solving for IRR, we get **Gross IRR = 5.72%**

Alternatively, we can use the XIRR Function on Excel: **=XIRR(values, dates, 0)**

The following table computes the cash outflows and cash inflows, for the computation of Net IRR:

Cash Inflows and Cash Outflows: Net IRR for Worst-case Scenario:

(INR in thousands)

Particulars	Jan 01 2019	Dec 31, 2019	Dec 31, 2020	Dec 31, 2021	Dec 31, 2022	Dec 31, 2023
Outflows:						
Capital Contribution	(500000)					
Initial Set-up Cost	(12500)					
Yearly Expenses		(3000)	(3000)	(3000)	(3000)	(3000.000)

Particulars	Jan 01 2019	Dec 31, 2019	Dec 31, 2020	Dec 31, 2021	Dec 31, 2022	Dec 31, 2023
Management Fees (incl. GST)		(9735)	(9558)	(10443)	(11505)	(12390.000)
Incentive Fees (2023)						-
Tax Expense (2023)						(21780.356)
Total Outflows:	(512500)	(12735)	(12558)	(13443)	(14505)	(37170.356)
Gross Asset Value						700000.000
Total Inflows:						700000.000

From the above table, it is important to note that:

- Timing of every cash flow is crucial. The Manager will call capital at the beginning of the first year. Similarly, initial set-up cost will also be incurred at the beginning of the first year. Other outflows, such as the yearly fund expenses, management fees and GST on the fees will be paid at the end of every year. Similarly, tax expenses are paid, at the end of 2023.
- Incentive Fees will not be paid to the Investment Manager in the last year of the fund life, on account of low Net Asset Value of the fund.

Using the XIRR function on Excel and solving for IRR, we get **Net IRR = 3.38%**

Conclusion:

From the IRRs calculated, we observe that:

- Net IRR can substantially be below the Gross IRR, if the fund has high fixed costs in terms of set-up costs, operating expenses, management fees and incentive fees.
- The decrease in Net IRR can be more in a Worst-case scenario, when the Investment Manager is generating average or below average returns. The following table illustrates the observation:

Particulars	Gross IRR	Net IRR	Change	Change (%) Over Gross IRR
Best-case Scenario	15.26%	12.77%	2.49%	16%
Worst-case Scenario	5.72%	3.38%	2.34%	41%

Since the Gross IRR and Net IRR computed in the example is for the entire life-cycle of the Fund, the same can be treated as Since-Inception IRR and Life-time IRR of the Fund.

7.3.2 Yield to Maturity (YTM)

The coupon rate on debt instruments is fixed based on the credit rating of the issuer, interest rates in the economy and prevailing market rates of corporate debt. However, depending on the periodicity and timing of the payment of such interest, the 'yield' or the IRR could be different.

According to Bloomberg, 'yield' is the 'effective interest paid on a bond or note'. Yield is therefore the effective rate of interest earned on an investment considering the periodicity of the cash flows arising therefrom either on account of interest payments or principal repayments. For the computation of yield, what is important is the timing of the investment outflow and the inflows arising from receipt of investment income or gains and in the case of debt, the timing of the return of principal amounts as well.

$$\text{Effective Rate } r = (1 + k/m)^m - 1$$

Where r is the effective rate of interest, k is the nominal rate of interest, and m is the frequency of compounding per year.

The YTM is the IRR of an investment from the beginning of the instrument till the date of maturity. This is typically used in fixed tenor debt instruments. Mathematically, the YTM is the IRR that makes the present value of the cash flows receivable from a debt investment equal to the present value of the initial investment. It can be depicted by the following equation:

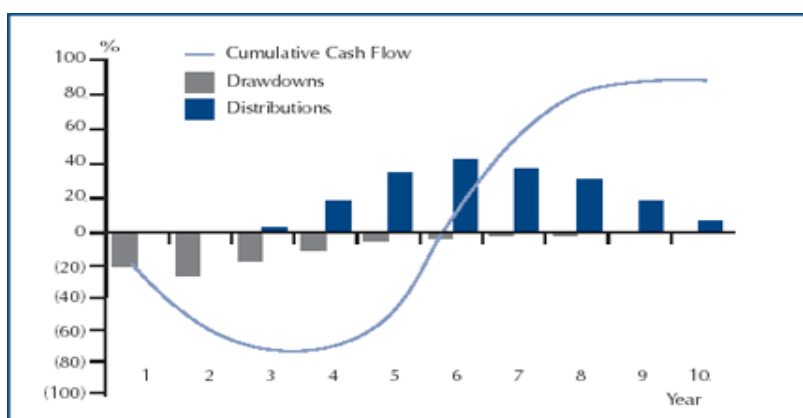
$$P = \frac{C}{(1+r)} + \frac{C}{(1+r)^2} + \dots + \frac{C}{(1+r)^n} + \frac{M}{(1+r)^n}$$

Where P is the present value of initial investment in a debt instrument, C is the annual cash flow, M is the maturity value, and n is the number of years left to maturity. The computation of YTM can be done on Microsoft Excel or any other spreadsheet using the 'IRR' function.

7.3.3 The J Curve

It is relevant to understand the pattern of return behaviour in Category I AIFs and Category II AIFs based on the life cycle of the fund. There would be a significant difference between fund performance metrics in the vintage years of the fund cycle vis-a-vis its maturity years.⁴⁶ The cash flows of the fund are initially negative during its investment period as investments are still being made because of fees and expenses on the returns. Returns start to improve and will become positive once the investments start to generate yield and are realised. This, coupled with the fees noted above, results in the cash flow profile known as the 'J curve'. The difference between the Gross IRR and the cumulative cash flow will, in all probability, be exaggerated as the total return statement should include the value of unrealised investments. As the fund reaches its maturity years, the gap reduces and by the close of the fund the cumulative cash flows equal the cumulative total return. The J curve is represented in the diagrams shown below.

Exhibit 1: Cash Flow Behaviour over Fund Life Cycle – J Curve⁴⁷



It may be observed from above that the IRR behaviour is based on the cash flow generated by the fund. In the initial years, cash flow is negative as the fund is drawing down committed capital and investing. The underlying investments would not have significant value at that stage as the process has just begun. Exits are not envisaged during those years and so the fund does not get back any return of cash invested. Therefore, distributions are insignificant in those years. Though the fund calculates the IRR based on underlying value of the investments, the fund value would still be in the negative, thereby yielding negative IRRs.

In subsequent years (year 4 onwards), the value accretion in investee companies is encashed through exits and distributions due to which the positive cash flow has peaked in year 6. The distributions continue till year 10 and cash flow remains positive. This is reflected in

⁴⁶“The term "vintage year" refers to the milestone year in which the first influx of investment capital is delivered to a project or company” - Investopedia. This is an important marking to arrive at the cumulative return on an investment because the return may vary for each phase of investment in an investee company depending on its growth cycle. In an AIF context, the years during which the fund is in initial investment mode are the vintage years. If the vintage years of a fund coincide with a boom economy, entry valuations could be high thus reducing overall returns, Similarly, if the vintage years occur at the bottom of the business cycle, returns may get magnified due to favourable entry pricing.

⁴⁷Source: venturechoice.com

increasing IRRs which reach the peak, as the fund enters its maturity years, in year 8. In the given figure, since most of the distributions are completed by year 8, the IRR does not grow in year 9 and 10 but remains stable at the peak.

It may also be inferred from the above discussion that IRR depends on the fund valuation (whether fully distributed or not) during the fund life and only on cumulative distributions upon winding up of the fund. Hence the behaviour of the IRR in a J curve pattern.

7.3.4 Multiples Method

Performance of AIFs can be ascertained by computing the Gross IRR and Net IRR, at the end of any reporting period. Apart from the return generated by an AIF, investors are more concerned with the amount of actual investment return “distributed” by the fund. If a fund is generating superior returns, only to reinvest back in the Fund, investors will need to repeatedly bear all the market risks on such return earned for the subsequent years. Distribution of capital by the Fund is the most important parameter for judging the performance of the fund. The Investment Manager, investing in illiquid securities, through a recognized stock exchange platform or otherwise, should be able to distribute realized profits to the investors, thereby controlling the inherent illiquidity risk within the fund. Investors shall not treat “Fund Return” as “Investor Return”, until the return earned has been distributed in the form of dividends, interest, and distribution or in any other manner.

7.3.4.1 PIC Multiple

Paid-in Capital or PIC Multiple - The PIC multiple measures how invested the fund is. It is calculated by dividing the PIC by the Capital Commitments. For example, if a fund has commitments of INR 1000 crore out of which INR 800 crore has been paid in by investors, the PIC Multiple is 0.80 or 80%. The more the PIC percentage, the better are the prospects for the fund to get fully invested. A high PIC means that the fund is near the end of its drawdown phase and has invested most of committed capital.

7.3.4.2 Distributions to Paid-in Capital (DPI)

Distributed to Paid in Capital (DPI) - This can also be called the realisation multiple. It measures the amount that has been paid out to investors. It is calculated by dividing cumulative distributions to investors divided by paid in capital.

$$\text{DPI} = \frac{\text{Total Distributions}}{\text{Total Capital Contributions}}$$

This multiple tells the investors how much money they got back. This is better for evaluating a fund later in its life because there are more distributions to measure against.

Investors may prefer the Distributions from the fund to be made early, if the fund is generating average returns. Hence, in such circumstances, a high value of DPI is preferred by the investors in the early years of the fund. However, if the fund is generating above-average returns, the investors may prefer the Distributions to be deferred, to stay invested in the fund.

For example, If the total distributions to date cumulate to INR 400 crore, on the total PIC of INR 1000 crore, the DPI at fund level amounts to 0.40 or 40%.

7.3.4.3 Residual Value to Paid-in Capital (RVPI)

Residual Value to Paid in Capital (**RVPI**) - Early in a fund, RVPI or the unrealised multiple is more representative of future returns than DPI. However, such investments still bear the market risks relating to the investments and do not guarantee a return similar to the past returns of the funds. The RVPI measures the remaining market value of the fund's capital (i.e. AUM of the fund) which has not yet been realised. It is calculated by dividing the residual value (or fair market value) of underlying investments by the PIC.

$$\text{RVPI} = \frac{\text{Assets under Management}}{\text{Total Capital Contributions}}$$

Investors need to keep in mind that the residual value is an estimate and is not always accurate depending upon the valuation methodology used for unrealised assets. Investors always prefer the AUM of the fund to be increasing. If the returns generated by the fund are above-average, the AUM increases at a faster rate and the investors would prefer a high RVPI, in such circumstances. However, if the fund generates average or below-average returns, the investors would not prefer a high RVPI and ask for distributions or redemptions.

For example, if the residual value has been estimated at INR 1100 crore, the RVPI would amount to 1.10 for a capital of INR 1000 crore.

7.3.4.4 Total Value to Paid-in Capital (TVPI)

Total Value to PIC (**TVPI**) also known as Multiple on Invested Capital (**MOIC**) is the fund's investment multiple and the fundamental metric in measuring private fund performance. Simple to understand and use, it measures the total value created by a fund. It can be calculated in two ways: (1) By dividing cumulative distributions + residual value of unsold

investments by the PIC. (2) It can also be found by adding together the DPI and RVPI. This multiple is what is commonly referred to as '**Net Multiple**'. Since the RVPI is incorporated, the TVPI will fluctuate until the fund is fully realised.

In the given example above, the TVPI would amount to 1.50 which is also the aggregate value of the DPI and the RVPI.

The TVPI of fund performance using the ROI metric at the fund level can be measured as follows.

$$TVPI = \frac{\text{Cumulative Distributions} + \text{Valuation of unrealised assets}}{PIC} - 1 \times 100$$

At the individual investor level, the DPI can be measured as follows:

$$DPI = \frac{\text{Cumulative Net Distributions to Investor}}{PIC \text{ of the Investor}} - 1 \times 100$$

Depending upon the status of the investor in the fund, preferential rights if any and the tax rate applicable to the investor, the DPI for the investor may be different from the TVPI at the fund level.

While the ability to highlight unrealised returns is a benefit of the ROI metric, it can be a double-edged sword if the perceived remaining value of an investment does not materialise. Consistently large MOIC to RVPI ratio should give investors and managers a red flag and perhaps encourage them to revisit the underlying asset valuations.

The behaviour of the above metrics (DPI, RVPI and TVPI) can be ascertained from the following:

1. Before the fund makes capital calls and commences its investing phase, the TVPI is less than 1, i.e. the fund corpus is reduced by the amount of fees and expenses chargeable to it.
2. During its vintage years and growth cycle of the investments, the fund's value is largely captured in the unrealized value of its investments, i.e. the RVPI.
3. As the fund begins to harvest its investments, the DPI begins to rise. By the time the fund has fully exited all its investments, the DPI becomes complete and the RVPI is reduced to zero. At this stage the DPI = TVPI. Till such final stage is reached, DPI + RVPI = TVPI.

Example 7.2: DPI, RVPI and TVPI:

Fund ABC is a close-ended Category I AIF launched on January 01, 2019. Following are the details:

All the assets of the fund are reinvested in the next year and net assets of the fund are distributed, at liquidation.

- **Best-case Scenario** – Above-average Net Returns for the Fund, above 12 percent p.a.
- **Worst-case Scenario**– Average Net Returns for the Fund, less than 12 percent p.a.

Committed Capital	INR 50 crore
Total No. of units issued	5,00,000
Fund-life	5 years

The below table summarizes the value of Net Assets of the fund in both scenarios, at the end of each year, as per the calculations made in all the previous examples:

Particulars	Best-case Scenario (INR)	Worst-case Scenario (INR)
Unrealized AUM:		
Net AUM (as on December 31 2019)	56,42,34,000.00	53,47,65,000.00
Net AUM (as on December 31 2020)	63,29,95,000.00	52,49,42,000.00
Net AUM (as on December 31 2021)	75,08,71,000.00	57,40,57,000.00
Net AUM (as on December 31 2022)	87,85,70,000.00	63,29,95,000.00
Distributions:		
Distribution made on December 31, 2023	101,70,66,623.00	66,03,29,644.00

Calculate and analyse TVPI, DPI and RVPI for all five years.

Solution:

For the purpose of calculating the TVPI, DPI and RVPI, we summarize the data for all five years as under:

Best-case Scenario:

Particulars	2019 (INR)	2020 (INR)	2021 (INR)	2022 (INR)	2023 (INR)
Total Capital Contribution (A)	50,00,00,000	50,00,00,000	50,00,00,000	50,00,00,000	50,00,00,000
Total Distributions (B)	-	-	-	-	1,01,70,66,623
Assets Under Management (Unrealized) (C)	56,42,34,000	63,29,95,000	75,08,71,000	87,85,70,000	

Particulars	2019 (INR)	2020 (INR)	2021 (INR)	2022 (INR)	2023 (INR)
DPI [D = B/A]	-	-	-	-	2.03
RVPI [E = C/A]	1.13	1.27	1.50	1.76	-
TVPI [F = D+E]	1.13	1.27	1.50	1.76	2.03

In 2023, since total net assets under management were distributed, value of unrealized assets is NIL.

Worst-case Scenario:

Particulars	2019 (INR)	2020 (INR)	2021 (INR)	2022 (INR)	2023 (INR)
Total Capital Contribution (A)	50,00,00,000	50,00,00,000	50,00,00,000	50,00,00,000	50,00,00,000
Total Distributions (B)	-	-	-	-	66,03,29,644
Assets Under Management (Unrealized) (C)	53,47,65,000	52,49,42,000	57,40,57,000	63,29,95,000	
DPI [D = B/A]	-	-	-	-	1.32
RVPI [E = C/A]	1.07	1.05	1.15	1.27	-
TVPI [F = D+E]	1.07	1.05	1.15	1.27	1.32

Conclusion:

- In the best-case scenario:
 - TVPI is constantly increasing every year, at an increasing rate. This indicates above-average performance of the fund.
 - DPI is high at 2.03 in the last year. The fund has returned 1.03 rupee on every 1 rupee (or 103%), over five years. Investors would prefer to stay invested in the fund, till liquidation, due to the increasing TVPI. This measure can be used in addition to the Gross IRR and Net IRR.
 - RVPI is also constantly increasing every year, as the unrealized assets in the fund have generated above-average returns.

- In the worst-case scenario:
 - TVPI and RVPI are not consistent through the life cycle of the fund. In 2020, the TVPI as well as the RVPI dropped, indicating a below-average performance of the fund.
 - DPI is low at 1.32 in the last year. The fund has returned 32 paisa on every 1 rupee (or 32%), over five years. Investors would not prefer to stay invested in the fund for all the five years and seek redemption of capital, before liquidation of the fund.

TVPI, DPI and RVPI can be used to compare the fund performance with industry peers.

For the purpose of comparing the performance of Fund ABC with its peers, let us compare its performance with Fund XYZ, as follows:

Particulars	2019	2020	2021	2022	2023
Fund ABC:					
TVPI	1.13	1.27	1.50	1.76	2.03
DPI	-	-	-	-	2.03
RVPI	1.13	1.27	1.50	1.76	-
Fund XYZ:					
TVPI	1.12	1.31	1.55	1.82	2.01
DPI	-	0.15	0.33	0.50	2.01
RVPI	1.12	1.16	1.22	1.32	-

On comparison of TVPI, DPI and RVPI of Fund ABC and Fund XYZ, the following can be inferred:

- Both funds have constantly increasing TVPI, which is an indicator of above-average fund performance.
- Fund XYZ has distributed the assets starting from Year 2 of its operations, which has not impacted the fund performance, as seen in the increasing RVPI of the fund, in Year 2, Year 3 and Year 4.
- There is a minimal difference in the TVPI of Fund ABC and Fund XYZ in all the five years. However, Fund XYZ has also distributed its assets consistently, which decreases the market risk for the investors in the fund.
- On comparison of all the three measures, Fund XYZ is a superior fund for the purpose of investing in the long term.
- If the TVPI of Fund ABC would have been substantially higher than TVPI of Fund XYZ, it would have depended on the investors to choose either of the funds, based on their risk-return profile and time horizon.

7.3.5 The Kaplan-Schoar Public Market Equivalent (KS-PME)⁴⁸

For Category I AIFs and Category II AIFs, this method satisfies the requirements of adopting a benchmark to the listed markets in measuring the performance of an AIF. As Category I and II AIFs are primarily investing in unlisted companies or start-ups, it is difficult to benchmark their performance due to lack of a comparable fund or a broad-based index. Hence, the KS-PME measures the relative efficiency of the Category I and II AIFs investments vis-a-vis index returns from the listed equities market. It measures the returns from the index between the relevant dates of the AIF measurement, i.e. the date of capital calls, distributions and the valuation date. By adopting the market rate of return as the compounding factor, it compounds the capital calls and distributions to the valuation date. It then calculates the TVPI of the resultant figures. If the market adjusted TVPI is greater than 1, it means the AIF outperformed the market and vice versa. Therefore, this method is nothing but the measurement of market adjusted TVPI. It is represented as:

$$\text{KS-PME} = (\text{Sum of future value distributions} + \text{NAV}) / \text{Sum of future value capital calls}$$

Example 7.3: Calculation of KS-PME

Date	Y0	Y1	Y2	Y3	Y4
Capital Calls	-20	-30			
Distribution			0	0	20
Unrealised NAV					120
Market returns based on index movement	18%	14%	16%	22%	17%
Compounding Factors	1.18	1.14	1.16	1.22	1.17
Cum. comp Value of Capital calls	-23.6	-26.9 -34.2	-31.2 -39.7	-38.0 -48.4	-44.55 -56.63
Comp Value of Distribution + NAV (A)					140
Comp Value of Capital Calls (B)					101.18
KS-PME = (A) / (B)					1.38

⁴⁸ Kaplan, S. & Schoar, A. (2005). Private Equity Performance: Returns, Persistence, and Capital Flows. Journal of Finance, 60, 1791–1823.

In the given example, since the KS-PME is 1.38, the AIF has performed significantly better than the market.

7.3.6 Direct Alpha⁴⁹

This method is a slight variation over the KS-PME method in that it measures the superior/inferior performance of the AIF as a percentage over market returns thereby quantifying the alpha directly. We can use the same example given above to illustrate this method.

Example 7.4: Calculation of Direct Alpha

Date (1)	Capital Call (CC) (2)	Distribution (D) (3)	NAV (4)	Net Cash Flow (5)=(2)+ (3)+(4)	Market returns (5)	FV (CC) (6)	FV (D) (7)	FV (NAV) (8)	Net FV of Cash Flow (9)=(6)+(7)+(8)
Y0	-20	-	-	-20	18%	-44.55*			-44.55
Y1	-30	-	-	-30	14%	-56.63 [#]			-56.63
Y2	-	-	-	0	16%	-	-	-	0
Y3	-	-	-	0	22%	-	-	-	0
Y4	-	20	120	140	17%	-	20	120	140
	Fund IRR[§]			35%		Direct Alpha[§]			10%

*-44.55 is calculated as: $[-20 \times (1.18) \times (1.14) \times (1.16) \times (1.22) \times (1.17)]$

[#]-56.63 is calculated as: $[-30 \times (1.14) \times (1.16) \times (1.22) \times (1.17)]$

§ Fund IRR and Direct Alpha is calculated using 'IRR' function in excel.

⁴⁹ Griffiths, B. (2009). Estimating Alpha in Private Equity, in Oliver Gottschalg (ed.), Private Equity Mathematics, 2009, PEI Media

In the above illustration, the fund has an IRR of 35% and direct alpha of 10% i.e. the fund has outperformed the market which has an IRR of 25% (35%-10%).

7.4 Pre and Post Tax Returns

7.4.1 Impact of Direct Taxes

The choice of jurisdiction is important for an AIF. Setting-up the AIF in an IFSC enjoys tax benefit, in comparison to an AIF set-up in other jurisdictions within India. Similarly, certain off-shore jurisdictions, such as Mauritius, Singapore or Netherlands provide tax benefits on income accrued and received in India, based on the Double Tax Avoidance Agreement (DTAA) signed between income tax authorities of India and the tax authorities of such jurisdiction.

7.4.2 Impact of Indirect Taxes

AIFs pay professional fees on an annual basis to multiple service providers, such as Fund Administrators, Registrars, Custodians, Auditors, Brokers, Investment Advisors and other third-party professional experts. The services provided by such external service providers are taxable on a yearly basis, at the rate of 18% of GST. Apart from services of external service providers, the fund also pays Management Fees and Trusteeship Fees, which are taxable at the rate of 18% of GST. This substantially impacts the cost of investments for the fund and can decrease the potential returns for investors.

III. Performance Benchmarking:

7.5 Benchmarking

Performance Benchmarking is a crucial process for investors to monitor the returns generated by AIFs, on an on-going basis. Performance Benchmarking can also be used for comparison of the returns generated by the AIF with the returns generated by other comparable funds.

Benchmark is the comparable fund or index having similar risk return characteristics as the AIF being monitored. Benchmark Return is the return generated by the chosen benchmark, over the reporting period. Refer Box 10.4 about features of a right benchmark.

Box 7.2: Selecting an Appropriate Benchmark – Adapted

As per CFA Institute, the benchmark for a segregated account is often chosen by the client, prospective client, or consultant, whereas the composite or pooled fund benchmark is generally chosen by the firm. The GIPS standards require that the benchmark chosen for any composite or pooled fund must be an appropriate total return benchmark. A benchmark is appropriate if it reflects the composite's or pooled fund's investment mandate, objective, or strategy. There may

be multiple benchmarks, however, that meet this single criterion. Firms should therefore consider additional characteristics of valid benchmarks when selecting a benchmark. A valid composite or pooled fund benchmark is one that is:

- specified in advance. Although this scenario may not always be the case, firms should select a composite or pooled fund benchmark prior to the evaluation period.
- relevant. The benchmark reflects the investment mandate, objective, or strategy of the composite or pooled fund.
- measurable. The benchmark is quantifiable
- unambiguous. The constituents of the investable universe can be clearly identified and priced.
- representative of current investment options. The firm has current knowledge of the investable universe.
- accountable. The firm selects the benchmark and is accountable for any deviations from the benchmark.
- investable. It is possible to forgo active management and simply hold the benchmark.
- complete. The benchmark provides a broad representation of the segment of the market to which it pertains.

AIF defines an investment strategy in its Private Placement Memorandum (PPM), which is specifically followed by its Investment Manager. Due to different investment strategies followed across AIFs which may invest across varying asset classes, derivative contracts or by taking varying level of leverage, it is difficult to construct a benchmark for every Category of AIFs, in the Indian Alternative Investment Market.

In such a scenario, the Investment Manager can benchmark the fund performance against a broad-market index, depending on the market-cap of the securities in which the fund primarily investments. The Investment Strategy followed by the Investment Manager outlines the targeted market sectors and market-cap of companies in which the fund may primarily invest. With the detailed investment strategy, an investor may choose to benchmark the fund performance against the most appropriate broad-based market indices, published by National Stock Exchange of India (NSE) and Bombay Stock Exchange of India (BSE). Such index returns can be used as an indicative benchmark, if not a perfect benchmark, to monitor and compare the performance of an AIF.

Some Category AIFs follow an 'absolute-return' strategy, which aims at making investments, independent from the broad market movements. Such funds invest through leveraged positions, concentrated positions, long/short positions or market neutral positions in equity derivatives, commodity derivatives, index derivatives and other unconventional investment methodologies. The benchmark for 'absolute-return' strategies may be fixed rate, pre-determined by the Investment Manager at the time of launching the fund scheme, such as 10 percent per annum. Absolute Returns are not benchmarked against a broad-based market index or a relative benchmark. If the yearly returns are more than the pre-determined rate specified by the investment manager, the fund is said to have over-performed in that year, and vice-versa. The computation of returns may be done on shorter reporting intervals as well, such as monthly or quarterly.

7.5.1 Benchmarking for Category I AIFs and Category II AIFs

Category I AIFs and Category II AIFs are investing in unlisted securities and early-stage start-ups. Hence, the investment managers cannot benchmark their performance against broad-based indices. Moreover, one fund may have a thematic approach of investing in a particular industry, while another fund may have a sector-agnostic approach of investing across all industries. Hence, it becomes difficult to benchmark performance of these funds, as one fund may not have a direct comparison with performance of other funds in the market. In such scenario, one of the most common forms of benchmarks used was the Public Market Equivalent (PME).⁵⁰

7.6 Benchmarking Agencies

As discussed earlier, performance benchmarking for AIFs is very subjective. The Investment Manager may use one benchmark for the purpose of reporting, while the investors would prefer to use another benchmark. There is a need for an industry benchmark for the AIF industry, to compare the performance of every Category of AIFs, based on the specific investment strategy followed.

In this regard, SEBI has mandated to develop an industry benchmark to compare the performance of AIF industry against other investment avenues including global opportunities and has also recommended the formation of market-wide Benchmarking Agencies.⁵¹ Any association of AIFs which in terms of membership, represents at least 33 percent of the number of AIFs, may notify one or more Benchmarking Agencies, who shall enter into agreements with every AIF for carrying out the benchmarking process.

Any AIF, which has completed minimum 1 year from the date of First Close, shall report performance-related data, cash-flow data and scheme-wise valuation data to such Benchmarking Agencies. The AIF shall enter into an agreement with the relevant Benchmarking Agency in order to maintain confidentiality of data, so reported.

The Benchmarking Agencies shall collect the relevant data from all AIFs and maintain relevant database of fund performance, based on the investment strategy followed by the Funds. Such performance database will enable the comparison of funds following a similar investment strategy, during comparable fund tenure. AIFs would be required to disclose the benchmarked performance, as derived by the Benchmarking Agency, in all marketing

⁵⁰Refer to section 9.8.5 under Chapter 9 of this workbook.

⁵¹SEBI Circular No.: SEBI/HO/IMD/DF6/CIR/P/2020/24 dated February 6, 2020 and SEBI/HO/IMD/DF6/CIR/P/2020/99 dated June 12, 2020 on Disclosure Standards for Alternative Investment Funds (AIFs).

materials and investor reports. This will enable investors to access performance data of AIFs, with accurate benchmarking.

SEBI has also laid down detailed operational guidelines for implementation of performance benchmarking (see Box 10.5).

Box 7.3: Operational Guidelines for Implementation of Performance Benchmarking

Section A:

- (a) Performance Benchmarking shall be done on a half-yearly basis based on the data as on September 30 and March 31 of each year.
- (b) AIFs/Schemes that have completed at least one year from First Close, shall provide all the necessary information/data to the Benchmarking Agencies.
- (c) AIFs shall provide data on cash flows and valuation of their scheme-wise investments to the Benchmarking Agencies in the form and format required by each Benchmarking Agency. The format of data reporting shall mandatorily include details of valuation principles and the name of the Valuation Agency appointed by the AIF.
- (d) Periodicity of valuation of investments shall be as provided in the SEBI (Alternative Investment Funds) Regulations.
- (e) Data provided for March 31 of every year shall be audited data and for September 30 may be unaudited data.
- (f) Assets under Management (AUM) for the purpose of reporting and benchmarking shall be the value of total capital drawn down under the Scheme.
- (g) The performance reporting and benchmarking shall be carried out on pre-tax Net Asset Value (NAV) of the Scheme.
- (h) Benchmarking Agencies shall compile the data received from AIFs and create comparable industry performance benchmarks for the various categories of AIFs i.e. Category I, II and III, separately for each year since 2012. The industry performance benchmarks will be disseminated in a manner that is accessible to the public.
- (i) Considering the diverse investment strategies and investment avenues that can be deployed by an AIF within the same category of AIF, additional performance benchmarks may be created, based on certain other parameters [besides those covered under (i) above]. Benchmarking Agency shall ensure that such performance benchmarking shall be based on objectively verifiable parameters like instrument of investment, tenure/vintage of the fund, focus sectors, etc.
- (j) Benchmarking Agencies shall provide a Performance Benchmark Report to the individual AIFs/Schemes vis-à-vis the industry benchmarks.
- (k) Each Benchmarking Agency shall clearly provide the basis of benchmarking of individual AIFs/Schemes as well as calculation of the industry benchmark, along with the Benchmark Report.
- (l) The performance data and benchmarks shall be reported in both INR and USD terms.

Section B:

- (m) Benchmarking Agencies may create customized Performance Reports, at the specific request of an AIF/ Scheme, in the following manner:
 - (i) Identification of the set of AIFs that meet the particular criteria on which customized performance report is to be generated.
 - (ii) Such identification may be either on the basis of self-attestation by the relevant AIFs or by independent verification by Benchmarking Agencies.
 - (iii) Receipt of express consent of the AIFs whose data is needed for creating such report.

- (iv) Preparation of customized performance reports may be a fee-based service, as decided mutually between the AIFs and the Benchmarking Agencies.
- (v) Customized performance reports thus generated shall be called 'Performance Report' as against the nomenclature "Benchmark Report", which shall be used for the standard benchmark reports generated based on SEBI mandate.

Currently, there are three benchmarking agencies appointed by the Indian Private Equity and Venture Capital Association (IVCA)⁵² and have published AIF benchmarks for all Categories of AIFs, in USD and INR terms. These benchmarks published by CRISIL, NSE and Preqin cover performance data of the AIFs.

For Category I AIFs and Category II AIFs, the benchmarking agencies provide benchmarks based on vintage years to bring in uniformity in the comparison of every sub-category of funds, with similar first close timeline. These benchmarks use aspects such as pooled internal rate of return (IRR), investment multiples and ratios such as distribution to paid-in capital (DPI), residual value to paid-in capital (RVPI), and total value to paid-in capital (TVPI).

SEBI further has clarified that Manager of AIFs shall timely report valuation of investment portfolio to performance benchmarking agencies.⁵³ In order to comply with this, the Manager of AIFs shall ensure that:

- a specific timeframe for providing audited accounts by their investee company is included as one of the terms in subscription agreement / investment agreement with the investee company. This shall help AIFs to report valuation based on audited data of investee companies as on March 31st to performance benchmarking agencies within the specified timeline of 7 months⁵⁴
- valuation based on audited data of investee company is reported to performance benchmarking agencies only after the audit of books of accounts of the AIF, within the stipulated timelines

7.6.1 Role of a benchmark in evaluating alpha generated by an AIF

Alpha (α) is the excess return generated by an AIF, as compared to the benchmark return. For the purpose of comparison, the benchmark return should be computed for the same time period over which the fund return was generated.

Alpha is computed using a common method known as Capital Asset Pricing Model (CAPM), as discussed in Chapter 5. First, Expected Return $[E(R)]$ is computed using the CAPM. Thereafter, Alpha is calculated as the difference between the Return (R) achieved and Expected Return $[E(R)]$ i.e. **Alpha (α) = R – E(R)**

⁵² <https://www.ivca.in/resources/performance-aifs>

⁵³ SEBI Circular No.: SEBI/HO/AFD/PoD/CIR/2023/97 dated June 21, 2023 on Standardised approach to valuation of investment portfolio of AIFs.

⁵⁴ SEBI Circular No.: SEBI/HO/AFD/PoD-1/P/CIR/2024/123 dated September 19, 2024.

To understand Alpha, let us calculate Alpha for Fund XYZ with the following details:

Example 7.5:

Scenarios are taken for computation of Alpha:

- Best-case Scenario – Above-average Net Returns for the Fund, above 12 percent p.a.
- Worst-case Scenario– Average Net Returns for the Fund, less than 12 percent p.a.

Particulars	Best-case Scenario	Worst-case Scenario
Net IRR	12.77%	3.38%
Beta	1.3	1.5
Repo Rate	6.00 %	
1-year CRISIL AIF Index – Cat I	9.25%	

Calculate and analyse the Alpha for Fund XYZ.

Solution:

Particulars	Best-case Scenario	Worst-case Scenario
Expected Return [$E(R) = R_f + \beta \cdot (R_m - R_f)$]	$5.60\% + 1.30 \cdot (9.25\% - 5.60\%)$ = 10.35%	$5.60\% + 1.50 \cdot (9.25\% - 5.60\%)$ = 11.08%
Alpha (α) = Net IRR – E(R)	$12.77\% - 10.35\%$ = 2.42%	$3.38\% - 11.08\%$ = -7.70%

Conclusion:

- Net IRR figures are taken instead of Gross IRR. This is on the assumption that investors ultimately bear fixed expenses and fees of the fund.
- 1-year CRISIL AIF Index – Cat I index is taken as the reference benchmark.
- On observation, the time period for all risk and return measures are identical. Net IRR is calculated on a yearly basis.
- Beta has changed for Best-case scenario and Worst-case scenario, as market risk taking in difficult market conditions would be higher. Such risks are non-diversifiable, which indirectly increases Beta of the fund.
- On comparison of the Expected Return in best-case scenario and worst-case scenario, the Expected Return has increased in the worst-case scenario, when it should decrease due to unfavourable market conditions. This is one of the limitations of the CAPM Model.

There is a big gap between the Alpha generated by the Fund in the Best-case scenario and the negative Alpha in the Worst-case scenario. This is primarily due to big difference in IRR and increased Beta in the worst-case scenario.

7.7 Worked out Case⁵⁵

In the following case, all the above discussions relating to AIF fund performance evaluation and investor returns under various scenarios are illustrated.

In order to appreciate the various technical descriptions and workings given in this worked out example, readers are advised to familiarise the concepts of Management Fees and Expenses that are borne at fund level and at investment management level, preferred return and additional returns, distribution waterfall and catch up and clawback from the discussions provided before.

Let us consider the following information.

The Alpha Fund is launching a new scheme in the initial year Y0. The AIF is a close ended fund with a life cycle of 8 years, excluding Y0. The fund has an investment period of 2 years starting from Y0. The first tranche is assumed to be raised on Day 1 of Y0 and the second tranche on Day 1 of Y1. In the first 3 years, since there are no cash realisations, the fund managers meet the fees and expenses from out of the corpus funds and thereafter from the realised cash before distributions. To make computations simpler, we assume that from Y4, all cash realisations net of fees and expenses are distributed and no taxes are considered.

The other assumptions required for computations are provided below:

Fund launch date - Beginning of Y0
Investment period - 2 years
Management Fee - 1% on Capital commitment for Y1
Expenses capped at 1% of Capital Commitment for Y1
Management Fee - 1.5% on Paid In Capital from Y2
Expenses capped at 1.5% of Paid in Capital from Y2
Fund Tenure - 8 years excluding Y0
Target Corpus - Rs. 1000 crore
Green shoe option - Rs. 1000 crore (considered achieved from Y1)
Investment to be reckoned as Rs. 700 crore from Y0 and Rs. 1300 crore from Y1
Additional Returns (Carry) - 20%
Hurdle Rate - 10%
Catch up available to Manager @25%
For simplicity in understanding it is assumed that all annual realisations net of fees and expenses are distributed.

⁵⁵ Figures used in this illustration are for representative purposes only and may not correspond to actual commercial terms in the AIF industry. Readers should not assume they are the normal template of commercial terms.

Further data provided on distributions made and the unrealised value of the fund investments are as follows:

Fund Distributions (Rs. Cr)	Y0	Y1	Y2	Y3	Y4	Y5	Y6	Y7	Y8
Cash Distribution to Investors	0	0	0	0	40	440	740	940	6840
Unrealised Value		500	1240	1200	1300	1500	1900	3000	0

Distributions are considered net of fees and expenses from the amount of cash realisations (assumed) for each year. No cash realisations are considered till Y3. Therefore, till Y3, fees and expenses are financed out of the fund corpus.

Step 1- Cash Flow

To determine the Cash Flow of the Fund, based on the given data, the workings are provided below.

Summary Cash Flow of the Fund (Rs. Cr)	Y0	Y1	Y2	Y3	Y4	Y5	Y6	Y7	Y8
Paid in Capital (Target + Greenshoe)	700	1300	0	0	0	0	0	0	0
Management Fees		20	30	30	30	30	30	30	30
Expenses		20	30	30	30	30	30	30	30
Fund Investments (outflow)		1840	0	0					
Distributions		0	0	0	40	440	740	940	6840
Cash Inflow from realisations		0	0	0	100	500	800	1000	6900
Closing balance	700	120	60	0	0	0	0	0	0

The paid in Capital is INR 2000 crore including the green shoe option which is assumed to have been achieved by beginning of Y1. In other words, the investment manager has been able to make the required investments by drawing the committed capital in full and completing fund investments by the end of the investment period except to provide for fees and expenses for Y2 and Y3 (i.e. $\text{INR } 30 \times 2 \times 2 = \text{INR } 120$). Accordingly, the drawdown is INR 700 crore at the beginning of Y0 and INR 1300 crore at the beginning of Y1 (fully utilised in Y0 and Y1). [Fund Investments (Outflow) = $700 + 1300 - 20 - 20 - (30 \times 4) = \text{INR } 1840$; where (30×4) represents the management fees and expenses for Y2 and Y3 respectively]

Management fees and expenses are computed as per the given data. All other items such as GST etc. have been ignored and the entire corpus is utilised to meet the fund investments and fees and expenses in Y1, Y2 and Y3. Thereafter, the cash inflow from realisations year on year has been calculated as the sum of the distributions and the fees and expenses.

Step 2 – Gross FIRR (Fund Level)⁵⁶

Now that we have the cash flow over the fund life cycle, we are in a position to compute the first metric, the FIRR achieved by the fund. Since the FIRR can be on gross or net basis, let us first consider the Gross FIRR, i.e. excluding the fees and expenses. The workings are provided below. The Gross FIRR has been computed by using 'IRR' function in excel.

	Y0	Y1	Y2	Y3	Y4	Y5	Y6	Y7	Y8
Invested Capital from Investors	-700	-1300	0	0	0	0	0	0	0
Cash Inflow from realisations	0	0	0	0	100	500	800	1000	6900
Value of Unrealised Investments		500	1240	1200	1300	1500	1900	3000	0
Cumulative Value (Incl distributions)	0	500	1240	1200	1400	2100	3300	5400	9300
Gross Cash Flow for FIRR over Fund Cycle	-700	-1300	0	0	100	500	800	1000	6900
Gross FIRR over Fund Cycle	25.45%								

Step 3 – Gross FIRR YoY

The Gross FIRR provided above is over the entire fund life cycle. Since the data is available, it can also be computed Year on Year (YoY) to understand the distribution of the returns as shown below.

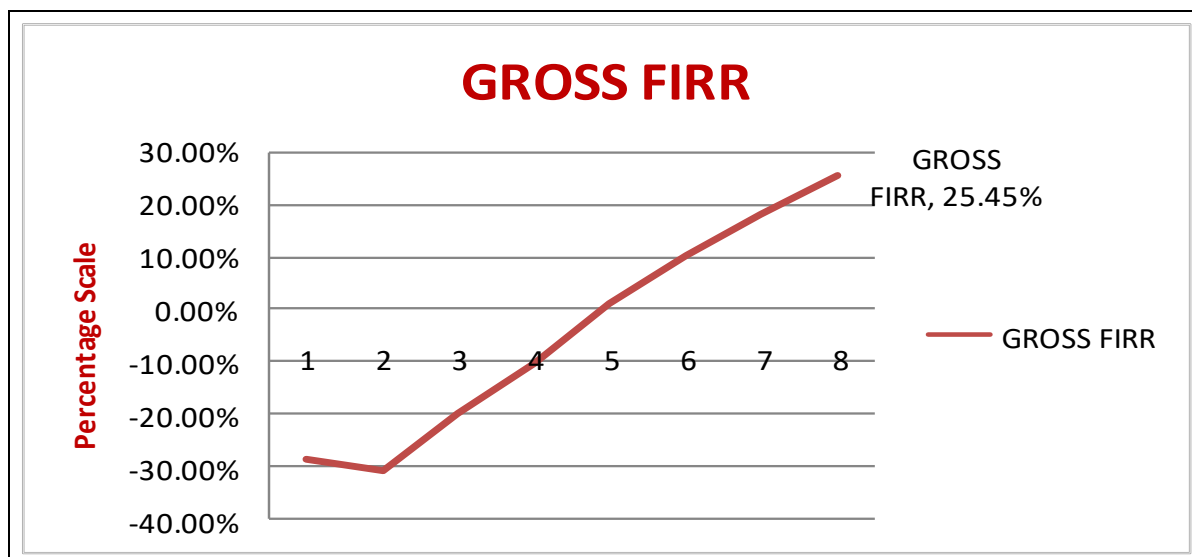
YoY Gross FIRR		Y0	Y1	Y2	Y3	Y4	Y5	Y6	Y7	Y8
Y1	-28.57%	-700	500	0	0	0	0	0	0	0
Y2	-30.57%	-700	-1300	1240	0	0	0	0	0	0
Y3	-19.72%	-700	-1300	0	1200	0	0	0	0	0
Y4	-10.13%	-700	-1300	0	0	1400	0	0	0	0
Y5	1.14%	-700	-1300	0	0	100	2000	0	0	0
Y6	10.24%	-700	-1300	0	0	100	500	2700	0	0
Y7	18.23%	-700	-1300	0	0	100	500	800	4000	0
Y8	25.45%	-700	-1300	0	0	100	500	800	1000	6900

⁵⁶In this Step 2, the following may be noted:

1. The fund start date is considered from the beginning of Y0. Therefore, for reckoning a full year of investment, INR 700 crore is represented in Y0 and INR 1300 crore in Y1 for computation of FIRR. In effect, INR 700 crore is invested for 2 years and INR 1300 crore for 1 year during the investment period.
2. The Cumulative Value is shown only at the invested capital amount during the investment phase and thereafter as the sum of the Cash flow from realisations and the value of unrealised investments. In Y8, the cumulative value will be sum of all cash inflow from realisations.
3. The figures described in 1 and 2 above are for representation purposes only and do not affect the computations. They can be appreciated better from Step 3 where the year-wise FIRR computations are furnished.

Step 4 – The J Curve for the Gross FIRR

As explained in the previous discussions, the returns from AIF are in the form of the J Curve reflecting negative returns in initial years and growing returns towards the maturity years. The graphical representation of the above distribution is provided below.



Step 5 – The Net Cash Flow (Fund Level)

From the Gross Cash Flow computed in Step 2, we can now arrive at the Net Cash Flow over the fund cycle. To do so, we need to calculate fees and expenses over the life cycle. Based on the given data, the fees and expenses have been computed. Accordingly, the net cash flow is arrived at as follows.

	Y0	Y1	Y2	Y3	Y4	Y5	Y6	Y7	Y8
Gross Cash Flow for FIRR over Fund Cycle	-700	-1300	0	0	100	500	800	1000	6900
Fees & Expenses		40	60	60	60	60	60	60	60
Cumulative Fees & Expenses over fund cycle		40	100	160	220	280	340	400	460
Net Cash Flow for FIRR over Fund Cycle	-700	-1300	0	0	40	440	740	940	6840

Step 6 – The Net FIRR

We can now repeat the same steps furnished above in the Computation of the Net FIRR. Over the life cycle of the fund, the Net IRR based on the net cash flow furnished in Step 5 is shown below.

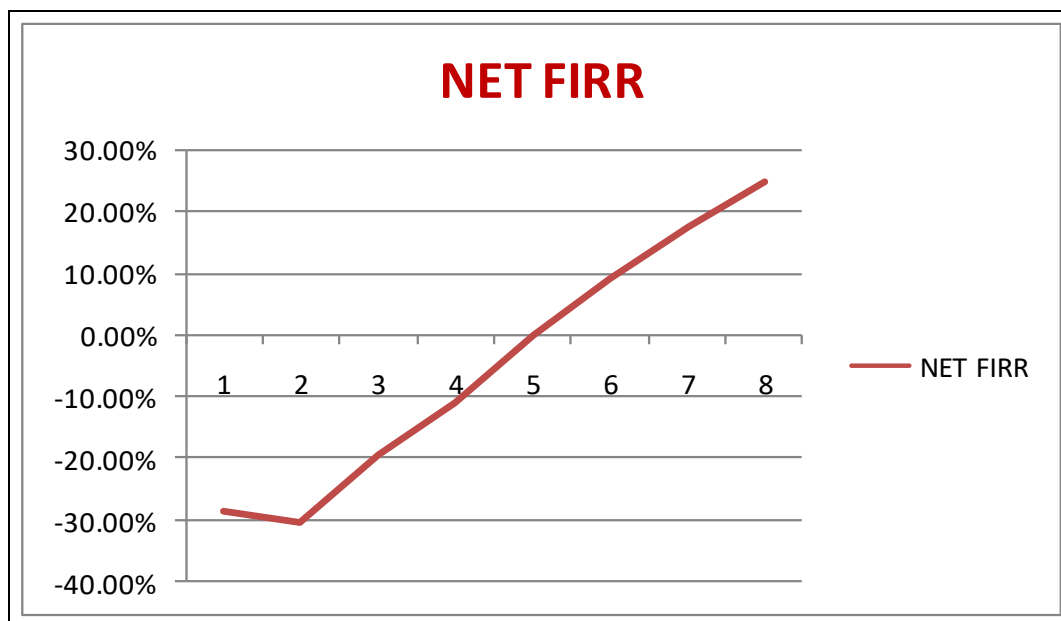
	Y0	Y1	Y2	Y3	Y4	Y5	Y6	Y7	Y8
Net Cash Flow for FIRR over Fund Cycle	-700	-1300	0	0	40	440	740	940	6840
Net FIRR over Fund Cycle	24.56%								

Step 7 – Net FIRR YoY

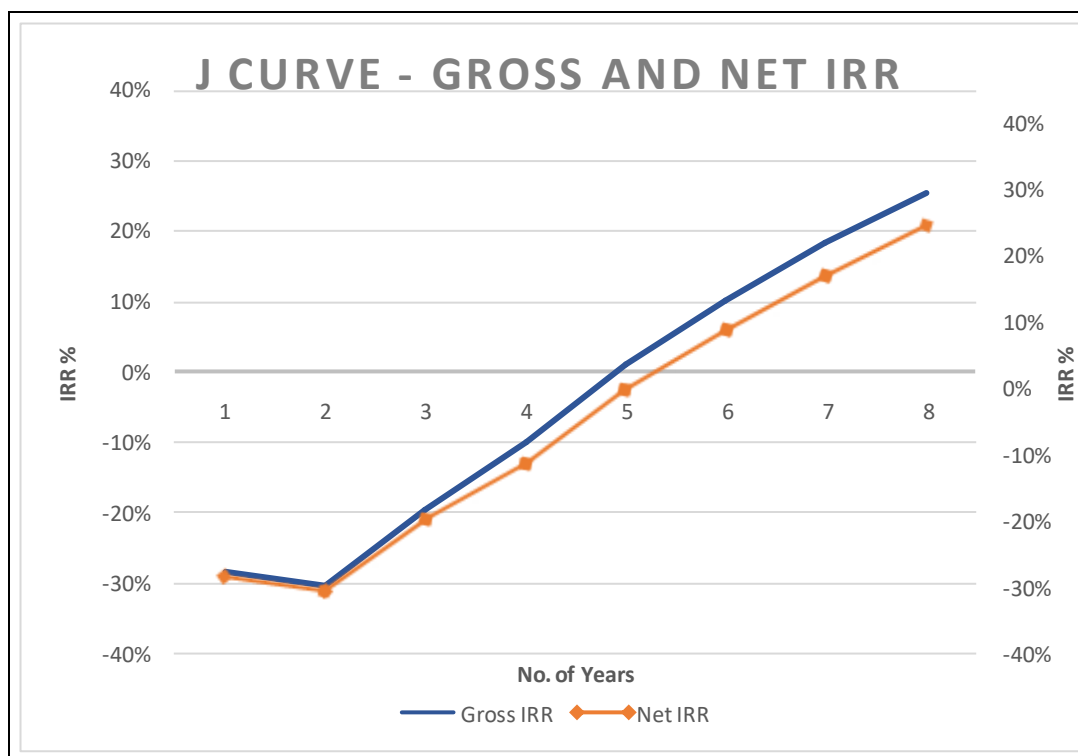
YoY Net FIRR		Y0	Y1	Y2	Y3	Y4	Y5	Y6	Y7	Y8
Y1	-28.57%	-700	500							
Y2	-30.57%	-700	-1300	1240						
Y3	-19.72%	-700	-1300	0	1200					
Y4	-11.31%	-700	-1300	0	0	1340				
Y5	-0.23%	-700	-1300	0	0	40	1940			
Y6	8.95%	-700	-1300	0	0	40	440	2640		
Y7	17.13%	-700	-1300	0	0	40	440	740	3940	
Y8	24.56%	-700	-1300	0	0	40	440	740	940	6840

Step 8 – The J Curve for the Net FIRR

The J curve plotted for the Net IRR would appear as follows.



If we now plot the Gross IRR and Net IRR on the same diagram, they would appear as follows



It may be observed from the above combined representation that there would be a difference in the trajectory of the Gross and Net FIRR's because of the deduction of fees, expenses and other deductibles such as taxes from the gross realisations and unrealised value of investments of the fund from time to time.

Step 9 – Hurdle Rate Distribution

The next step is to arrive at the distribution required to provide the investors their hurdle rate requirement of 10%. This computation is provided below.

Hurdle Rate Computation	Y0	Y1	Y2	Y3	Y4	Y5	Y6	Y7	Y8
Y1		-700	0						
Y2		-700	-1300	0	0	0			
Y3		-700	-1300	0	0	0			
Y4		-700	-1300	0	0	40			
Y5		-700	-1300	0	0	0	440		
Y6		-700	-1300	0	0	0	0	740	
Y7		-700	-1300	0	0	0	0	0	940
Y8		-700	-1300	0	0	0	0	0	0
Investor Cash Flow		-700	-1300	0	0	40	440	740	940
Investor FIRR									
Y8									10.00%

It may be observed from the above table that the investors would get their hurdle rate return satisfied only after the receipt of Year 8 final distribution since the fund gets wound up at the completion of Y8. The amount to be distributed in Year 8 to achieve the hurdle rate is INR 1460 crore after considering previous distributions.

Step 10 – The Distribution Waterfall

Since we have arrived at the Gross and Net FIRR, the next step is to understand how the distribution waterfall would work out for the given commercial terms between the investors and the manager as provided in the case. In this computation, we need to follow the required priority as per the data provided - (1) Return of invested capital and the hurdle rate to the investors, (2) Catch up to the extent of 25% of the balance available to the manager, (3) 80% of the residual balance to the investors and (4) the balance of 20% as carry to the manager.

The distribution waterfall is provided below:

Waterfall Computation (Rs. Cr)	Y1	Y2	Y3	Y4	Y5	Y6	Y7	Y8
Cash inflow from realisations	0	0	0	100	500	800	1000	6900
Less Fees and Expenses	0	0	0	60	60	60	60	60
Distributable Cash Flow	0	0	0	40	440	740	940	6840
Waterfall Sequence								
Investors (Hurdle Rate and Invested Capital)	0	0	0	40	440	740	940	1460
Catch up at 25%	0	0	0	0	0	0	0	1345
Investors Further Return (80%)	0	0	0	0	0	0	0	3228
Carried Interest (20%)	0	0	0	0	0	0	0	807
Total Distribution to Investors	0	0	0	40	440	740	940	4688
Distribution to Manager								
Management Fees	20	30	30	30	30	30	30	30
Catch Up and Carried Interest	0	0	0	0	0	0	0	2152
Total Distribution to Manager	20	30	30	30	30	30	30	2182

It may be observed from the above table that in Y8, the amount received by the investors (INR 4688 crore) and the managers (INR 2182 crore) add up to INR 6870 crore which is the amount available for distribution after expenses. The management fees for Y8 have been included in the amounts receivable by the manager.

The formulae used to calculate the following are as follows:

- Catch-up: 25% of (Distributable Cash Flow – Hurdle Rate to Investors) i.e. $25\% \times (6840 - 1460) = \text{INR } 1345$
- Investors' Further Return: 80% of Residual amount after Catch-up i.e. $80\% \times (6840 - 1460 - 1345) = \text{INR } 3228$

- Carried Interest: 20% of the residual amount after Catch-up i.e. $20\% \times (6840 - 1460 - 1345) = \text{INR } 807$

Step 11 – The ROI Metrics

It is now time to understand the ROI metric approach and compute the indicators discussed in the earlier paragraph. Accordingly, the DPI, RVPI and the TVPI for the distribution arrived at in the preceding steps are furnished below.

ROI METRICS									
		Y1	Y2	Y3	Y4	Y5	Y6	Y7	Y8
Distribution to Investors		0	0	0	40	440	740	940	4688
Paid in Capital	2000								
YoY DPI		0	0	0	0.02	0.22	0.37	0.47	2.344
Residual Value of Unrealised Inv.		500	1240	1200	1300	1500	1900	3000	0
YoY RVPI		0.25	0.62	0.6	0.65	0.75	0.95	1.5	0
YoY TVPI		0.25	0.62	0.6	0.67	0.97	1.32	1.97	2.344
DPI + RVPI		0.25	0.62	0.6	0.67	0.97	1.32	1.97	2.344

The paid-in capital in the above table is INR 2000 crore which is the total corpus including the green shoe option. It may be observed from the computation given above that the TVPI = DPI+RVPI.

Step 12 – The Investor Level Net IRR based on Distribution Waterfall

This is the last step in the required computations. The Gross and Net FIRR calculated in Steps 2 and 6 reflect the returns at the fund level but this is not what the investor gets since the final distributions are according to the carry arrangements between the investors and the manager. Accordingly, if we were to consider the third scenario of what exactly is the FIRR returned to the investor, it would be less than even the Net FIRR. This computation is furnished below.

Investor Net FIRR on Fund Maturity									
	Y0	Y1	Y2	Y3	Y4	Y5	Y6	Y7	Y8
Y1	-700	0	0	0	0	0	0	0	0
Y2	-700	-1300	0	0	0	0	0	0	0
Y3	-700	-1300	0	0	0	0	0	0	0
Y4	-700	-1300	0	0	40	0	0	0	0
Y5	-700	-1300	0	0	0	440	0	0	0
Y6	-700	-1300	0	0	0	0	740	0	0
Y7	-700	-1300	0	0	0	0	0	940	0
Y8	-700	-1300	0	0	0	0	0	0	4688
Investor Cash Flow	-700	-1300	0	0	40	440	740	940	4688
Investor FIRR									
	Y8	20.13%							

As may be observed from the above discussion, the return perspective of fund performance can be judged in several metrics based on fund level and investor level approaches. Distributors need to educate prospective investors on the need to comprehend these intricacies such as Gross and Net IRR at fund level, FIRR at investor level based on actual distributions (which could be lower) and the TVPI. This will pave the way for better negotiations and meeting of minds between investors and fund managers. It will also greatly mitigate mis-selling by distributors, expectation gaps of investors and their consequent adverse impact.

Template of Important Risk Factors at Fund Level and Investor Level⁵⁷

This is not intended to be an exhaustive list. The scheme related PPM would contain a more elaborate description and bigger list of risk factors.

A. GENERAL RISK FACTORS

1. Political, social and economic risks in India and how investments of the Fund can be impacted as a result of changes in the same
2. Risks related to global financial conditions
3. Impact of bankruptcy of portfolio vehicles/enforceability on ability of the Fund to earn returns
4. Risk of segregation of assets between funds/schemes/trustees not being available in third party suits/regulatory actions with respect to the Fund
5. Risk associated with the illiquid nature of the investment in the Fund (as may be applicable)
6. Risk of changes in accounting practices that may be adopted in relation to the Fund

B. RISKS RELATED TO PORTFOLIO INVESTMENTS IN PARTICULAR

1. Risk associated with the nature of the portfolio investments (type of company, type of instrument, pricing, non-controlling stake/minority interest, as may be applicable) and the possibility of inability of the Fund to deploy the entire capital raised
2. Risk related to the exit of the Fund from the portfolio investments and possibility of distribution in kind
3. Risk with regards to ability of the Fund to raise significant capital
4. Risk associated with the Fund investing with third parties
5. Risk associated with lack of insurance by the Fund against catastrophic events and other losses
6. Environmental related liabilities and risk to the Fund arising thereto
7. Risk associated with counter party's actions/default with respect to the Fund
8. Risk associated with change/change in control of parties in relation to the Fund
9. Risk associated with the managerial role the Fund may play *vis-à-vis* each portfolio company (example director seat/party to litigation/liabilities arising due to environmental damage, product defect, violation of government regulations and other similar liabilities)

⁵⁷The list is compiled largely based on the disclosure requirements prescribed by SEBI in Section X of Annexure 1 to the Circular No. SEBI/HO/IMD/DF6/CIR/P/2020/24 dated February 5, 2020.

C. RISK RELATED TO FUND STRUCTURE

This section will be specific to the structure adopted and attendant risks associated with the structure. Certain common themes across fund structures could be:

1. Performance risks
2. Risk associated with the ability of the Investment Manager/management team to identify and structure investments and divestments
3. Concentration risk
4. Risk associated with reliance on forward looking statements/market data
5. Risk associated with reliance on the trustee, manager and other decision-making committees
6. Risk associated with relying on third party service providers/intermediaries
7. Risk to investment on account of default on capital calls
8. Restrictions on withdrawal and transfer and risk associated with this (including receiving in-kind distribution). Also, risk associated with AIF not being an assured return product to be included.
9. Risk associated with indemnity and tax obligation of the investors to parties to the Fund

D. REGULATORY RISK FACTORS

1. Risk associated with obtaining SEBI registration and cancellation/suspension of SEBI certificate/other action by SEBI that may impact the operations of the Fund and Investment Manager.
2. Risk of uncertainty around the legal framework in which the fund/various parties to the Fund and portfolio entities operate in India. Also, risk in relation to litigation that may be faced by the Fund may also be highlighted along with the lack of jurisprudence as to certain aspects, in India.
3. Other regulatory risks including companies act, takeover code, enforcement risks, regulatory approvals including loss of registration etc.

E. TAX RELATED FACTORS

1. General Anti – Avoidance Rules, Permanent Establishment rules and its impact on the Fund/ its investors/ portfolio investments and risks associated with it.
2. Risks associated with change in tax laws, including renegotiation of tax treaties, relevant to the Fund and its investors.
3. Change in administrative interpretation/ application of tax laws and attendant risks therefrom.

F. SECTOR SPECIFIC RISK FACTORS

This can include risks associated with the specific sector/ strategy that the Fund will be focussing upon as a part of its investment strategy and objectives.

G. CURRENCY RELATED RISKS

1. Risks related to currency fluctuations arising from offshore investments in AIFs.
2. Risks associated with investment in offshore jurisdictions in case the Fund intends to invest abroad.

Sample Questions: Chapter 7

1. One of the key risks of AIF investment is:

- a. the risk of capital inadequacy
- b. the risk of inadequate provisioning against NPAs
- c. illiquidity risk**
- d. the risk of inadequate security creation

2. A fund has a PIC of 0.90. It means _____.

- a. that the fund is about to complete its final close.
- b. that it has only 10% NPA level
- c. that the fund has 90% recovery rate on its investments
- d. that it has drawn down most of the capital commitments**

3. The FIRR is a measure of return based on the _____.

- a. time value of money**
- b. profit potential of an investment
- c. accounting profit of an investment
- d. percentage of gross margin

4. Gross IRR and Net IRR of an AIF could be different because of which the following factors?

- a. Difference between expected rate of return and actual rate of return
- b. Unexpected changes in tax law
- c. Investor level cash flows being considered in the computation of Net IRR**

5. The MOIC of an AIF is the aggregate of its DPI and RVPI. State whether True or False.

- a. True**
- b. False

CHAPTER 8: LEGAL DOCUMENTATION AND NEGOTIATIONS

LEARNING OBJECTIVES:

After studying this chapter, you should know about:

- Various legal documentations in the context of AIFs and their importance
 - Trust Deed/ LLP Deed/ Memorandum and Articles of Association
 - Investment Management Agreement
 - Subscription Agreement and Side Letters
 - Private Placement Memorandum
 - Other Support Services' Agreement

8.1 Introduction

The term 'legal documentation' in the context of an AIF refers to the set of legal contracts and documents that define the AIF architecture and set out the binding roles and performance obligations of the connected parties in such a way that the outcome of the fund activity protects the interests of the investors and other stakeholders. The principal documents to be mentioned in this regard are – (1) the constitutional document of the AIF, (2) the contractual document governing the investment management, (3) the contractual document governing the investors' relationship with the AIF, (4) the Private Placement Memorandum (PPM) and (5) the various service agreements that define the roles and responsibilities of other stakeholders such as trustees, investment advisors etc. and service providers such as distributors.

To attract high quality investors, it is essential that the fund documents (including marketing literature prepared by the Fund and the distributors such as the 'Pitch documents' and the PPM) include an articulation on the fund's governance standards. Fund documents are an important aspect of the fundraising exercise. Fund documents also serve the very important purpose of making the whole fund structure bankable from a regulatory, commercial and contractual perspective so that investors are reassured of the protection of their interests.

8.2 The Trust Document / Limited Liability Partnership Deed / Memorandum and Articles of Associations

When the AIF is constituted as a trust, it is necessary to constitute it through a 'Trust Indenture' which is a registered document that is executed between the sponsor and the trustee to bring the trust into existence. This document is registered so as to give it the status of an incorporated juridical person. The sponsor is the settler of the trust who conveys the initial sum of money to the trustee towards setting up the trust and creating its assets. The trust document is also the instrument of trusteeship which is vested in the trustees of the AIF. The trust document has to be drafted carefully to conform to the 'determinate' status

of its corpus and is necessary to establish its status and tax treatment with the revenue officials under the Income Tax Act, 1961.

In the case of a Limited Liability Partnership (LLP) structure, the constitutional document would be the LLP agreement signed between the managing partners initially and thereafter it would induct the investors into the partnership. It would define the relationship between the partners and all commercial understanding between them contractually. The LLP is registered with the Registrar of Companies (ROC) to provide it with a legal persona.

If the AIF is constituted as a company, the manager would incorporate it with initial shareholders as subscribers to the Memorandum. The memorandum and articles of association are registered with the ROC and the company takes birth with a distinct legal entity.

The constitution document of the AIF is shared with all investors of the AIF alike, being the charter document, and also shared with SEBI for registering the AIF under the SEBI (AIF) Regulations.

8.3 The Investment Management Agreement

The Investment Management Agreement (IMA) is required to be entered into by and between the trustee (on behalf of the AIF) and the investment manager. This agreement not only sets out the terms of fund management by the manager but in effect, the trustee delegates all its management powers in respect of investment management to the investment manager, except for certain retained powers that are identified in the Indenture of Trust. The IMA is signed once for the trust as a whole and not signed at the launch of each scheme.

A trust structure permits ring fencing of the manager's liability (including from a fiduciary, breach of fund documents perspective) from that of the AIF's, because the manager is only a counterparty service provider to the AIF, unlike also being on the board of directors of an AIF which could be a company, or being a designated partner of an LLP. It is due to this reason why almost all AIFs in India are constituted as trusts and not as LLPs. There is also no reported case of an AIF in a company structure due to this reason.

Nowadays, investors are becoming increasingly cautious about providing excessive bandwidth to managers in terms of their functioning or commercial interests in the wake of the financial crisis in 2008 and several frauds that surfaced in fund management. There can also be a termination clause in the investment management agreement with the fund / subscription agreement that may provide for termination of services of the manager or withdrawal of the investor in the event if it has come to light that the interests of the investors and manager are grossly mis-aligned and there is a considerable moral hazard in continuance. These aspects need to be looked into carefully in drafting the agreement and provisions made therein for termination of management services.

‘For cause’ removal typically refers to the premature termination of the manager’s services to the fund by the investors, owing to events of default – mainly fraud, wilful misconduct, and gross negligence. Since these facts are subject to interpretation by the courts, such litigation could be long drawn and vexatious. Suitable dispute resolution provisions through arbitration could mitigate this risk to some extent.

8.4 The Subscription (Investor Contribution) Agreement

The Contribution Agreement is to be entered into by and between each contributor (i.e. investor), the trustee and the investment manager. This agreement sets out the terms between the AIF and the investor and is amenable for amendments as may be required from time to time. The Contribution Agreement sets out the conditionalities for an investor to participate in the AIF. Considering that most fund investments are about blind pool investing, the subscription agreements includes all aspects relating to fund investing such as computation of beneficial interest, drawdowns, distribution waterfall, commercial aspects of fees and expenses, fund governance structure, powers of the investment committee and so on. The Contribution Agreement for each Contributor is generally not shared with other Contributors, as it contains representations and warranties which may be specific to each Contributor.

Units representing unit capital held in the fund by an investor have to be issued in dematerialised mode only.⁵⁸ Accordingly, the investors will be able to receive their unit statements from the depository on periodical basis showing the balance held by them and transactions conducted during a particular period. Such requirement would be specified as part of the subscription agreement. This compliance requirement protects investor interests.

LLPs and companies have specific processes to receive contributions towards capital from their partners, shareholders. LLP provisions are contained in the Limited Liability Partnership Act. In case of a company, share allotment / application money, etc. are regulated concepts, which require compliance with the Companies Act, 2013. Since AIF investment arrangements require more flexibility between the terms governing the investors, AIF and the investment manager, a company structure will pose difficulties to set up an AIF. Hence, a trust structure has become the most popular to constitute an AIF and enter into subscription agreement for investor contributions.

8.4.1 Side Letters with Investors

In many instances, investors may seek specific investment arrangements with respect to their participation in the fund. Since these may not be generic to all investors but may be

available only to a few institutional or large investors, they are recorded separately in supplementary documentation known as the side letter(s). These are executed by the specific investor, the AIF and the investment manager. Most of the time, side letters relate to differential terms for charge of management fee, working of the distribution waterfall, participation rights in investment committees, investor giveback, etc. Sometimes, investors may also insist on including a protection right that would protect them from the risk of any other investor being placed in a better position than them. Side letter enforceability has not been tested adequately in Indian courts and they do have certain amount of legal risk for such investors. An investor may also insist on including a 'Most Favoured Nation' (MFN) clause to prevent any other investor being placed in a better position than itself.⁵⁹

However, it is important to note that the investment manager has a fiduciary duty towards other investors in the fund. Hence, the investment manager should ensure that they are not in breach of such fiduciary duty, in an attempt to provide differential rights to some large investors. To avoid such a breach of fiduciary duty, most investment managers create a separate class of units with differential rights, issued to large investors.

In global practice, AIFs may be set up in such a way that the key constitutional and fund terms are included in the charter documents, and only certain specific terms for some investors (which are carefully worded so as not be construed as prejudicial to other investors) are included in side letters. Such charter documents are executed by all investors to the fund, along with the fund and the manager while the side letters are not disclosed to the other investors since they are bilateral between AIF / investment manager and the specific investors. Therefore, only those terms which would only require individual right of action for an investor against the fund or the manager, and not impact the general operations of the fund vis-à-vis other investors, are contained in the side letter(s). Having side letters would generally make the job of an Advisor difficult to assess the risk for his investors, since he is unaware about the preferential rights already granted to the existing investors.

8.5 Private Placement Memorandum

The Private Placement Memorandum (PPM) is akin to an Offer Document detailing all the important information related to the AIF and its proposed investment activities. Such information is essential for institutional investors and high net-worth individual investors to analyse the suitability of the investment in an AIF, as per their risk-return objective. For an AIF looking to raise capital commitments, the PPM is the most important and informative

⁵⁹MFN Clause allows an investor to receive side letter entitlements, which can be used to protect themselves from less favourable terms or conditions in the PPM, as compared to the terms or conditions offered to other current or future investors.

document as it provides all necessary information required by sophisticated investors, which is not generally available in the public, to take informed investment decisions.

PPM contains all material disclosures about the AIF, such as parties comprising the fund structure (the manager, the key investment team, sponsors and trustees, custodians, bankers, auditors and legal advisors), details relate to targeted investors, fees and other expenses proposed to be charged from the fund, tenure of the scheme, conditions or limits on redemption, investment strategy, risk factors and mitigation, fund governance structure, conflicts of interest and procedures to identify and address them, performance history of the AIF and the manager, key terms of the investment management services, details of other service providers, process of winding up the scheme and all other information.

Perceiving the need to introduce common disclosure requirements for PPMs issued by AIFs, SEBI issued a circular that provides for templates of PPM for different categories of AIFs.⁶⁰ The summary disclosures in the PPM are listed below in Box 8.1.

Box 8.1: List of Disclosures in a PPM

SECTION – A

Section I: Executive Summary

Brief details of the AIF, scheme, sponsor, manager, affiliate entities if any, investment objective and strategy, allocation of corpus as per investment sector or geography etc., target corpus, classes of unit capital as applicable and basis of classification, terms of the Fund/ Scheme starting from the final closing date, extension applicable, if any, subject to AIF Regulations, minimum capital commitments sought, sponsor / manager commitment, subject to the minimum requirements under the AIF Regulations, commitment period (in number of years or months) including date of commencement and ending of the commitment period, drawdown terms, initial closing, subsequent closings and final closing, proposed management fee details, preferred return (Hurdle rate) as proposed in IRR terms or any other method, additional return or carried interest as proposed, expenses structure, distribution waterfall for each class of units, leverage strategies are required to be part of disclosures under this section.

Section II: Market Opportunity/ Indian Economy/ Industry Outlook

- General economic background and data, if any, that the Manager deems to be relevant from the perspective of the Fund/ Scheme with reliable sources cited for the data
- Investment outlook of the Sponsor/ Manager (including macro-economic and micro-economic factors) that may be relevant to the strategy of the Fund/ Scheme.
- Sector/ industry outlook that may be relevant to the strategy of the Fund/ Scheme.
- Any other aspect that the Manager/ Sponsor wishes to highlight in the context of the Fund's/ Scheme's investment strategy.

Additional information on this section may be provided in supplementary section.

⁶⁰SEBI Circular No.: SEBI/HO/IMD/DF6/CIR/P/2020/24 dated Feb 05, 2020 (issued on SEBI website on Feb 6, 2020) [<https://www.sebi.gov.in/legal/circulars/feb-2020/disclosure-standards-for-alternative-investment-funds-aifs-45919.html>]

Section III: Investment Objective, Strategy and Process

This section details the investment strategy with break-down into sectors, geographies, cap on investment in each investee company or sector, break-down of investible corpus for domestic investee companies and overseas companies, prescribed approvals required for change or deviation in investment strategy and any other additional details as may be necessary. A flow chart depicting the investment process in an investee company is also required to be furnished.

Section IV: Fund/ Scheme Structure

This section includes the following:

- A complete diagrammatic representation of the Fund/ Scheme structure disclosing all key constituents (e.g. sponsor, trustee, manager, custodian (if any), investment advisor (if any), offshore feeder (if any), offshore manager (if any), etc., as may be applicable); along with a brief description of the activities of the Fund/ Scheme and its constituents, jurisdictions that may be applicable (if identified), nature of relationship between each constituent of the Fund/ Scheme, as well as classes of units/ interest held by each constituent in the Fund vehicle(s);
- Brief description of the structure of the Fund/ Scheme (including segregation of assets and liabilities for multiple schemes of the Fund/Scheme, if applicable).

Section V: Governance Structure

It has to talk about the governance structure of the AIF, listing out details of the sponsor, trustee, manager, key investment team in the manager's organisation, valuation committee, investment committee, advisory board, if any, investor advisory committee, if any, investment advisor, if any etc.

Detailed information on the investment team members are also provided, such as qualification, prior work experience of every team members and Terms of reference of the committee constituted for approving the decisions of the Alternative Investment Fund⁶¹

Section VI: Track Record of Manager

The broad points included in this regard, for each fund (including schemes of the fund, as applicable) so previously set up (to be depicted in tabular form, with separate tables for separate funds) are as follows:

- Investment strategy of the fund
- Size of the fund
- Historical track record of the fund, i.e. performance of the fund over the last 6 months / 1 year / 3 years / 5 years (applicable for Category III AIFs)
- Number of investments made by the fund
- Amounts deployed by the fund
- Gross IRR (Internal Rate of Return) for the fund
- Gross MOIC (Multiple on Invested Capital)
- DPI (Distributed to Paid-in)
- RVPI (Residual Value in Multiple)

⁶¹Inserted by the SEBI (Alternative Investment Funds) (Second Amendment) Regulations, 2021.

- TVPI (Total Value to Paid-in)
- Description of portfolio companies and investment exits for the fund

The PPM shall categorically specify the type of manager i.e. (i) First Time Manager or (ii) Experienced Manager. In case of first time manager, disclosure in relation to previous funds, with which individual members comprising of the investment team for the Fund/Scheme were associated.

Section VII: Principal Terms of the Fund/ Scheme

This is the longest section in the PPM and discloses, in detail, the items listed out above in the Section I and additional items about the Fund/ Scheme. Investors need to understand the complete details that would be furnished under this section as it forms the basis for the entire investment paradigm.

Section VIII: Principles of Portfolio Valuation (pertains to Category I and II AIFs only)

This section broadly lays down the principles that will be used by the Manager for valuation of the portfolio company which inter alia includes:

- Details of the entity to be appointed as the Valuer of the Fund/ Scheme.
- Frequency of valuation of the portfolio companies.
- Valuation principles used by the Fund/ Scheme for valuation of portfolio companies - (whether the Fund/ Scheme follows the International Private Equity and Venture Capital Valuation (IPEV) Guidelines).
- Any other guiding principles relevant for the investors to know with respect to valuation of the Fund/ Scheme.

Section IX: Conflicts of Interest

This section lays out, in detail, all potential sources of conflicts of interests that the Manager envisages during the operations of the Fund/ Scheme and steps taken by the Fund for effective resolution of such conflicts. Such conflicts arising at following levels:

- At the level of employee of the management entity
- At the level of service providers of the Fund/ Scheme
- At the level of the Manager
- At the level of the Sponsor
- At the level of the investor
- At the level of members of various governance bodies (as described in section titled "Governance Structure and Investment Process")
- At the level of the Sponsor/ Manager group entity, in relation to various schemes managed by the Sponsor/ Manager.

Details on conflict of interest on account of warehousing of investments⁶² or making co-investments are also disclosed.

Section X: Risk factors

This section lays down risk related information as exhaustively as possible. All potential risk factors that the investors need to be aware of, in respect of their investments in the Fund/ Scheme, feature in this section. It tabulates specific risks attributable to specific type of instruments to be invested in by the Fund/ Scheme, i.e. risk specific to debt instruments, equity etc., risk factors specific to certain type of investors in the Fund/ Scheme, for example overseas investors. The broad categories of risk disclosures are the following:

- Risks related to Portfolio Investments in particular
- Risks Related to Fund/ Scheme Structure
- Regulatory Risk Factors
- General Risk Factors
- Tax related Factors
- Specific Risk Factors – related to specific sectors/ strategy that the AIF wishes to invest in
- Currency Related Risks – including risks related to investing overseas

Additionally, wherever applicable, the section also mentions the mitigation factors instituted by the manager for each of these risks.

Section XI: Legal, Regulatory and Tax Considerations

- Indian Trust Act, 1882 / Limited Liability Partnership Act, 2008 / Companies Act, 2013. Details as may be applicable regarding the constitution of the Fund/ Scheme.
- SEBI (Alternative Investment Funds) Regulations, 2012
- Relevant extracts of the SEBI (ICDR) Regulations, 2018 in so far as they relate to initial public offerings (IPOs), Qualified Institutions Placements (QIPs) and Preferential Allotments.
- Relevant provisions of the SEBI (Substantial Acquisition of Shares and Takeovers) Regulations, 2011 (Takeover Code), including open offer and disclosure requirements.
- Relevant provisions of the SEBI (Prohibition of Insider Trading) Regulations, 2015.
- Relevant provisions of the Prevention of Money Laundering Act, 2002 (the PMLA) and rules thereunder, including any amendments thereto.
- General and specific provisions to be highlighted from the Companies Act, 2013 depending on investment strategy/ type of instrument that the Fund/ Scheme seeks to invest in.
- Relevant provisions of FEMA that permit foreign investments into an AIF including conditions under Schedule 8 of Foreign Exchange Management (Non-debt Instruments) Rules, 2019.

⁶²Warehousing in the above context shall mean investment transactions that are made with an intention to park the securities for a period of time so as to be able to transfer or dispose them off at an appropriate later date. In such a transaction, the investor is acting either on behalf of an ultimate beneficiary or purely as a service provider. This shall not be confused with warehousing of deals which means building a pipeline of investment deals before the first close of a fund is achieved.

- If the AIF is foreign owned or controlled, relevant provisions from extant foreign investment laws as applicable to downstream investments may be provided.
- Other sector specific regulatory disclosures depending upon the sectors that the AIF may be exposed to as per the investment strategy.
- Competition law as may be applicable based on the investment strategy of the Fund/ Scheme to be provided.
- Tax regime as per the provisions of section 10(23FBA), section 10(23FBB), 194LBB and section 115UB of the Income Tax Act, 1961 and any potential risk factors that could be applicable to the Fund/ Scheme.
- Taxation applicability on individual incomes of the AIF
- General Anti Avoidance Rules
- Applicability of Goods and Service Tax Act, 2016.

Section XII: Illustration of Fees, Expenses and Other Charges

This is presented in a tabular format showing the total contributions received, the break-up of fees, expenses and other charges that will be charged to the fund and the net deployment of funds by the AIF year on year during its entire life.

Section XIII: Distribution Waterfall

This is also presented in tabular form showing scenarios as follows – (a) the fund is at a loss, (b) the fund is at no profit or loss, (c) the fund has earned profits but less than the hurdle rate, (d) the fund has earned profits equal to the hurdle rate and (e) the fund has earned profits in excess of the hurdle rate. The illustrative distributions should also be shown for each class of units separately.

The distribution waterfall shall also incorporate necessary disclosures in the waterfall arrangements with regard to fees and expenses. Those funds that have additional return arrangements as per the PPM shall show the distribution based on such additional return adjustments.

Section XIV: Disciplinary history

Disciplinary history of the following entities is provided: Sponsor, Manager, Trustee, Associates of Sponsor, Associates of Manager, Directors/ Partners of Sponsor, Directors/ Partners of Manager and Directors/ Partners of Trustee.

Section XV: Glossary

All terms used in the PPM including industry parlance terms should be explained in this section.

SECTION – B

This section of the PPM accommodates all additional disclosures that the AIF makes over and above the minimum disclosures prescribed in Section A of the PPM. These additional disclosures may refer to some of the individual sections stated above and/ or additional disclosures.

As per the SEBI (AIF) Regulations, the Investment Manager or Sponsor must launch AIF schemes after filing the PPM with SEBI, through a SEBI registered Merchant Banker, at least 30 days prior to launch of scheme, along with payment of scheme fee.⁶³ However, the application fee is not applicable in case of a launch of the first scheme by AIFs.

The Merchant Banker must exercise independent due diligence of all the disclosures in the PPM, satisfy itself with respect to veracity and adequacy of the disclosures and provide a due diligence certificate on a prescribed format by SEBI.⁶⁴ The details of the Merchant Banker shall be disclosed in the PPM. While filing the draft PPM at the time of registration or prior to launch of new scheme, the due diligence certificate provided by the Merchant Banker shall also be submitted, along with other necessary documents.

SEBI may communicate its comments, if any, to the merchant banker prior to launch of the scheme and the merchant banker shall ensure that the comments are incorporated in the placement memorandum prior to launch of the scheme. Further, AIFs are required to intimate SEBI regarding any changes in terms of the PPM on a consolidated basis, within 1 month of the end of each financial year.

Due to the specific disclosures prescribed by SEBI, PPMs have the status of regulated documents under the AIF regulations. SEBI scrutinises the PPM to consider the application for registration of a proposed AIF; all investors are expected to have read, understood and agreed to the terms of the PPM before making an investment in the AIF; and any changes to the PPM are matters of investor vote. All changes made to the PPM till the final version must be highlighted in the copy of the final PPM. It may be emphasized that, SEBI provides only observations on the PPM submitted to them and does not approve the document. The below text is generally shared by SEBI with all the AIFs submitting their PPMs:

“It is to be distinctly understood that submission of the PPM to SEBI should not in any way be deemed or construed that the same has been cleared or approved by SEBI. SEBI does not take any responsibility for the accuracy and correctness of disclosures, facts and claims made in the PPM and the capability and performance of the Manager. It is Manager’s responsibility to take all reasonable care to ensure that the information in the PPM is true and accurate in all material respects and in compliance with SEBI (Alternative Investment Funds) Regulations, 2012 and other applicable laws and that there are no material facts, the omission of which would make any statement in this memorandum, whether of fact or opinion, misleading. This requirement is to facilitate investors to take an informed decision for making investment in the proposed Fund/Scheme.”

Large Value Fund (LVF) schemes are exempt from filling their PPM through Merchant Bankers or incorporate comments by SEBI, as these schemes are launched under “intimation to SEBI” model. The PPMs for LVF schemes are filed with SEBI along with a duly signed and stamped undertaking by CEO and Compliance Officer of the Manager of AIF in SEBI

⁶³Not applicable for Large Value Fund of Accredited Investors.

⁶⁴SEBI Circular No.: SEBI/HO/IMD/IMD-I/DF6/P/CIR/2021/645 dated October 21, 2021 on Modalities for filing of placement memorandum through a Merchant Banker under SEBI (AIF) Regulations, 2012.

prescribed format.⁶⁵ Also, LVFs are exempted from the requirement of intimating any changes in the terms of PPM through a merchant banker. LVFs may directly file any changes in the terms of PPM with SEBI, along with a duly signed and stamped undertaking by CEO of the Manager of the AIF (or person holding equivalent role or position depending on the legal structure of Manager) and Compliance Officer of Manager of the AIF.⁶⁶

8.5.1 Additional Disclosures under PPM⁶⁷

Investor Charter

To facilitate investor awareness, SEBI has notified that all registered AIFs are required to bring out Investor Charter providing relevant information about the activities pertaining to the AIF. This Investor Charter is a document with details of services provided to investors, details of grievance redressal mechanism and responsibilities of the investors at one single place, for ease of reference. The Investor Charter to be published in the following manner:

- a) For new schemes, the AIF should disclose the Investor Charter in the PPM
- b) For existing schemes, the AIF should disclose the Investor Charter to the investors on their registered e-mail ID, as a one-time measure

The Investor Charter provides detailed information on the following: (see *Annexure 13.1*)

- Vision and Mission Statement
- Details of business transacted by the AIF, with respect to the investors
- Details of services provided to investors, as per SEBI (AIF) Regulations, at the time of:
 - On-boarding Investors
 - Obtaining investor consent for material changes to fund structure
 - Disseminating financial information of Fund
 - Providing Disclosures with respect to Material Risks associated with the fund and its portfolio investments.
 - Intimating any non-material changes in the operations of the fund
 - Grievance Redressal
- Timelines of every activity/service provided to investors, in accordance with SEBI (AIF) Regulations, specifically at the time of:
 - Providing Valuation-related disclosures
 - Providing transparency and making important disclosures
 - Handling complaints
- Details of grievance redressal mechanism and how to access it

⁶⁵ SEBI Circular No.: SEBI/HO/AFD/RAC/CIR/2022/088 dated June 24, 2022 on Guidelines for Large Value Fund for Accredited Investors under SEBI (AIF) Regulations, 2012 and Requirement of Compliance Officer for Managers of all AIFs.

⁶⁶SEBI Circular No.: SEBI/HO/AFD/PoD/CIR/2024/028 dated April 29, 2024.

⁶⁷Vide SEBI Circular No.: SEBI/HO/IMD-I/DOF9/P/CIR /2021/682 dated December 10, 2021 on Publishing Investor Charter and Disclosure of complaints by AIFs.

- Responsibilities of Investors, with respect to:
 - a. Informing and Educating themselves
 - b. Timely updating the KYC and information required by Intermediaries
 - c. Abiding by the Contribution Agreement
 - d. Using services of right financial intermediaries, consultants and advisors
 - e. Maintaining Confidentiality of Information

Disclosure of Complaints

In addition to the Investor Charter, all registered AIFs are required to disclose the data on investor complaints received against them (AIFs) and each of their schemes; and redressal status thereof in the following manner:

- a) For new schemes, the AIF should include a separate chapter on its Investor Grievance Redressal in the PPM
- b) For existing schemes, the AIF should update the PPM within 1 month from end of each financial year and inform the investors and SEBI on a consolidated basis.

AIFs shall maintain investors' complaints data for: (a) every quarter, ending March, June, September and December, every year and (b) last three Financial Years, from the date of submission. The data needs to be compiled within 7 days from the end of quarter and disclosed to investors and SEBI. These disclosure requirements are in addition to the existing requirements pertaining to the investor grievance handling mechanism.

8.5.2 PPM Audit

In order to ensure compliance with the terms of PPM, it is mandatory for AIFs to carry out an annual audit of such compliance at the end of each financial year. The audit shall be carried out by either internal or external auditor/ legal professional. However, audit of sections of PPM relating to 'Risk Factors', 'Legal, Regulatory and Tax Considerations', 'Track Record of First Time Managers', 'Illustration of Fees and Expenses' and 'Glossary and Terms' shall be optional.

The findings of the audit, along with corrective steps, if any, shall be communicated to the Trustee or Board or Designated Partners of the AIF, Board of the Manager and SEBI within 6 months from the end of the financial year. The terms of contribution or subscription agreement (by any name as it may be called), shall be aligned with the terms of the PPM and shall not go beyond the terms of the PPM.

The minimum prescribed PPM disclosures as per Section A stated above and audit requirements thereon are not applicable in two situations –

- For angel funds as defined in the SEBI (AIF) Regulations 2012.

- AIFs/ Schemes in which each investor commits to a minimum capital contribution of INR 70 crore (USD 10 million or equivalent, in case of capital commitment in non-INR currency) and also provides a waiver to the fund from the requirement of PPM in the SEBI prescribed template and annual audit of terms of PPM, in the prescribed manner.

In addition to above, the requirement of audit on PPM terms is not applicable to those AIFs which have not raised any money from its investors. In this regard, such AIFs need to provide a Certificate from a Chartered Accountant within 6 months from the end of the financial year.⁶⁸

The scope of such PPM audit would be:

- Review of compliance with the minimum subscription for each class of units
- Implementation of the Investment strategy
- Disclosure of the affiliates and any transactions undertaken with them
- Investment policy of the Category I AIF/ Category II AIF and review of investments undertaken in accordance with the investment policy
- Review of fund flow in purchase and sale of securities on sample basis to ensure compliance with the investment strategy
- Review of the class of units of the Category I AIF/ Category II AIF in existence during the year in accordance with the class of units stated in the PPM
- Review of the capital commitments received and drawdowns made during the year in accordance with the terms of the PPM
- Review of management fees charged for each class of units of the Category I AIF/ Category II AIF
- Review of the distributions and additional return charged to the investors
- Review of relevant information and reference sources for data disclosed in the section on Market Opportunity/ Indian economy / Industry Outlook
- Ensure compliance with the disclosures required on the Scheme structure and relevant disclosures on all key constituents of the Category I AIF/ Category II AIF
- Ensure that the Category I AIF/ Category II AIF has policy on the governance framework to check for potential Insider Trading, compliance with Anti-money Laundering norms, potential conflict of interests, among others
- Review the Disclosure and compliance with the list of responsibilities entrusted to Trustee, Sponsor and Manager.
- Ascertain the Role of the key investment team or investment committee and the decision-making process of the investment committee or the Board of the Investment Manager

⁶⁸ Vide SEBI Circular No.: SEBI/HO/IMD/DF6/CIR/P/2020/99 dated June 12, 2020.

- Review of the practices in connection with the consequences of default by investors including penalty, forfeiture, and suspension of rights, among others
- Review of working in connection with the transfer of units of the Fund or withdrawal of units of the Fund/ Scheme, on a sample basis

A standard reporting format for PPM Audit Report has been prepared by SEBI in consultation with pilot Standard Setting Forum for AIFs (SFA). The reporting format will be reviewed periodically by the pilot SFA in consultation with SEBI. AIFs are required to submit such PPM Audit Reports to SEBI on the SEBI Intermediary Portal.⁶⁹

8.5.3 Material Changes in PPM

The SEBI (AIF) Regulations also provide for a compulsory exit option in case the change to the PPM is a case of a 'material change'.⁷⁰ Material changes can alter the investor's decision to remain invested in the fund. Such changes include: (1) change in sponsor / manager (not including internal restructuring within the group), (2) change in control of sponsor / manager, (3) change in fee structure or hurdle rate which may adversely affect investors etc. The implications of material changes in PPM are discussed in detail in Chapter 15.

In India, fund managers need to function under the confined framework of the SEBI (AIF) Regulations, the fund documentation and the PPM and any material departures could trigger the exit rights of investors.

8.6 Wrapper

A wrapper is a supplement attached to the Private Placement Memorandum of the domestic fund distributed at offshore locations (in case of 'unified structure'). This helps to achieve compliance with the requirements for private placement of the securities of an offshore fund to investors in jurisdictions outside India.

8.7 Support Services Agreements

Support services consist of several outsourced functions of the AIF administration as well as the offices of the investment manager. A few of the support service agreements are discussed as follows:

⁶⁹ SEBI Circular No.: SEBI/HO/AFD/SEC-1/P/CIR/2024/22 dated April 18, 2024.

⁷⁰Vide SEBI Circular No.: CIR/IMD/DF/14/2014 dated June 19, 2014

8.7.1 Agreement with Merchant Banker

According to the AIF Regulations and allied circular⁷¹, an AIF shall launch scheme(s), subject to filing of placement memorandum with SEBI through a SEBI registered Merchant Banker. The Merchant Banker shall independently exercise due diligence of all the disclosures in the placement memorandum, satisfy itself with respect to veracity and adequacy of the disclosures and provide a due diligence certificate in the prescribed format. The details of the appointed merchant banker have to be disclosed in the PPM. AIFs are required to intimate SEBI regarding any changes in terms of placement memorandum on a consolidated basis, within one month of the end of each financial year. Such intimation shall also be submitted through a Merchant Banker, along with the due diligence certificate provided by the Merchant Banker in the prescribed format. The Merchant Banker appointed for filing of placement memorandum shall not be an associate of the AIF, its sponsor, manager or trustee.

Since the role of the merchant banker has been stipulated akin to companies going to the public market with due diligence responsibility, the appointment of the merchant banker under a suitable agreement with the AIF becomes an imperative. Such agreement, inter alia, needs to be drafted to include necessary covenants from both parties. While the AIF covenants shall include disclosure of information by the issuer company according to law and regulation, providing necessary details, documents and records and extending support for the conduct of due diligence by the merchant banker. The merchant banker shall provide covenants with regard to performance of their duties and responsibilities under the appointment in accordance with and in fulfilment of the AIF Regulations. In addition, the agreement shall stipulate the commercial terms for the merchant banker for services rendered and shall have adequate provisions to ensure arm's length distance between the parties. The AIF shall also safeguard its own position vis-à-vis the merchant banker in appointing a merchant banker with proper credentials and track record along with adequate experience in AIF business matters and PPMs. The agreement shall stipulate the scope of work, process for conduct of the due diligence and filing of the report and associated steps to be taken by the merchant banker in a time bound manner to ensure quality of service. Necessary representations and warranties from the merchant banker shall be included in the agreements to this effect.

8.7.2 Agreement with Custodian

A Custodian is a SEBI registered service provider in the capital market facilitating investment activity for FPIs in the Indian capital market. The word 'custodian' has not been specifically defined under the statute but it encapsulates all the functions that an investment back office

⁷¹SEBI/HO/IMD/IMD-/DF6/P/CIR/2021/645 dated October 21, 2021

has to perform. These include acting as the clearing member of the clearing corporation of the concerned stock exchange for the purpose of clearing the transactions from time to time, safe keeping of securities records and physical assets (such as commodities), reporting to SEBI as may be required, maintenance of books and records, tax and regulatory compliance. Under the existing SEBI regulations, appointing a custodian is mandatory for all AIFs. Each scheme can have a different custodian however in order to segregate assets and liabilities of the said scheme.

With regard to AIF activity, Regulation 20(11) of the AIF Regulations provide for the appointment of a custodian as follows –

1. Sponsor / Manager of AIFs shall appoint a custodian for safekeeping of the securities of the fund.
2. Custodian, appointed by the Sponsors/ Managers of Category III AIFs shall keep custody of securities and goods received in delivery against physical settlement of commodity derivatives.⁷²
3. Custodians shall report information regarding investments of AIFs as specified by SEBI.

In addition to the aforementioned requirement of safekeeping of the securities, custodians appointed by AIFs are also involved in obtaining tax certificate for the AIF, settlement of trade with respect to investment in listed securities, to liaison with companies with respect to post trade corporate action, and any other activity as delegated to it by the AIF as part of the custodial agreement with the custodian. In the case of Category III AIFs with a breach of their permitted leverage limits, the custodian shall report to SEBI providing name of the fund, the extent of breach and reasons for the same before 10 a.m. on the next working day.

In view of the above regulatory requirements and significant role of the custodians in compliance, back-office support and reporting, the custodial agreement is an important documentation in the constitution of the AIF. The custodian agreement is a legally binding contract entered into between the AIF and its custodian. It shall provide for the role and scope of services of the custodian in compliance with regulatory requirements and shall contain all standard provisions with regard to satisfactory performance by the custodian. It shall also include covenant of mutual obligations and responsibilities of the parties apart from specifying the commercial terms of engagement of the custodian. The investment manager has to ensure that proper responsibility fixation on the custodian has been provided for in the agreement for the back-office functions so that there is enough contractual redressal in any event. The Sponsor/Manager needs to appoint custodian for a scheme of an AIF prior to the date of first investment of the scheme.

8.7.3 Agreement with Distributor

⁷²Vide SEBI (Alternative Investment Funds) (Amendment) Regulations, 2019 w.e.f. May 10, 2019.

The Distribution Agreement is drawn up between the Investment Manager of the AIF and the agency being appointed as a distributor for the AIF products. It defines the role of the distributor and prescribes a Code of Conduct. Some important covenants of a distributor are on the following lines:

- Distributor agrees not to make any statement or do any act, including any alteration, addition, modification or erasure on any marketing literature and documents of or issued by or provided by the Investment Manager or filled up by investor.
- Distributor agrees that he will not incur or purport to incur any debt or liability on behalf of Investment Manager unless so specifically authorised in writing by the Manager.
- Investment Manager may from time to time, on reasonable notice, arrange seminars, meetings and training sessions relating to AIF Schemes or generally and the Distributor agrees to make all reasonable endeavours to attend all such programmes.
- The Distributor shall not allow or offer to allow, either directly or indirectly, as an inducement, to a prospect or a Unit Holder, to purchase or redeem or transact Units, any rebate of any amount.

The agreement provides for the commercial arrangement between the parties, support from the manager in terms of providing marketing literature etc. and representations and warranties that bind both parties. Usually, the agreement provides for the products and / or geography to which the agreement extends between the parties.

SEBI issued a circular which prescribed the framework for distribution / placement commissions to be paid on AIF products. The important aspects are listed below⁷³ –

1. AIFs shall ensure that investors who approach the AIF through a SEBI registered intermediary which is separately charging the investor any fee (such as advisory fee or portfolio management fee), are on-boarded via Direct Plan only which involves no payment of commissions.
2. In other cases, AIFs shall disclose distribution fee/placement fee, if any, to the investors of AIF/scheme of AIF at the time of on-boarding.
3. Category III AIFs shall charge distribution fee/placement fee, if any, to investors only on equal trail basis i.e. no upfront distribution fee/placement fee shall be charged by Category III AIFs directly or indirectly to their investors. Further, any distribution fee/placement fee paid shall be only from the management fee received by the managers of such Category III AIFs.
4. Category I AIFs and Category II AIFs may pay upto one-third of the total distribution fee/placement fee to the distributors on upfront basis, and the remaining distribution fee/placement fee shall be paid to the distributors on equal trail basis over the tenure of the fund.

⁷³Circular No. SEBI/HO/AFD/PoD/CIR/2023/054 dated April 10, 2023

8.7.4 Investment Advisory Agreement

In an offshore fund structure, the board or the investment manager of the offshore fund may delegate or seek on-site support for its investment management functions from an on-site investment advisor in India. If the Offshore Fund delegates investment advisory responsibilities to a separate entity, it needs to sign an Investment Advisory Agreement which contains the general terms under which such investment advisor renders advice in respect of the transactions for the Fund's board. While the offshore investment manager is responsible to the offshore investors, the local investment advisor provides advice in deal assessment, execution and post-investment management.

The Investment Advisory Agreement contains the general terms under which such investment advisor renders advisory functions. In some cases, there could be an offshore advisor coupled with an on-shore sub-advisor depending upon the type of fund and other complexities in its structure, investment strategy or fund management.

8.7.5 Agreement with Depository Participant

According to the regulatory requirements, AIFs are required to hold their investments in dematerialised form, subject to conditions specified by SEBI from time to time.

SEBI has also clarified that any investment made by an AIF on or after July 1, 2024 shall be held in dematerialised form only, irrespective of whether the investment is made directly in the investee company or is acquired from another entity. To comply with these requirements, the AIF has to enter into an agreement with a depository participant of NSDL or CDSL and open a demat account for holding securities on behalf of the AIF. The agreement provides for the services provided by the depository participant, the fee structure and contractual obligations associated therewith.

Investor Charter for Alternative Investment Funds

A. Vision and Mission Statement:

Vision

To develop the Alternative Investment Fund (AIF) industry on professional and ethical lines and maintain high standards of governance and transparency.

Mission

- Maintain high professional and ethical standards within the AIF industry.
- Comply with all applicable regulations and co-operate with the regulators in all aspects of the AIF activity.
- Act in a fiduciary capacity towards the investors.

B. Details of business transacted by the organization with respect to the investors:

- To raise capital from domestic and global investors.
- To invest in portfolio companies in accordance with investment strategy stated in Fund documents, with an objective to generate positive returns for the stakeholders including investors.
- To distribute returns to the investors as per the fund documents.

C. Details of services provided to investors:

1. On-boarding of investors.

- 1.1 Sharing of Private Placement Memorandum (PPM).
- 1.2 Account opening with the AIF:
 - Completing KYC of investors and registration of KYC with KRAs.
 - Sharing of copies of fund documents with investors.
 - Entering into contribution agreement with investor.

2. Obtaining investor consent for material changes to fund structure

- 2.1 Change in the sponsor or the manager of the AIF.
- 2.2 Change in control of the sponsor or the manager of the AIF.
- 2.3 Material changes to terms of PPM
 - Term of Fund.
 - Investment Strategy.

-Increase in fees and charges.

2.4 Winding up of Fund/ Scheme prior to expiry of tenure.

3. Dissemination of financial information of Fund.

3.1 Net Asset Value of Fund/ Scheme.

3.2 Financial information of investee companies.

3.3 Information on performance of scheme/fund.

4. Disclosures with respect to material risks associated with the fund and its portfolio investments.

4.1 Any inquiries/ legal actions by legal or regulatory bodies in any jurisdiction.

4.2 Any material liability arising during the tenure of the fund.

4.3 Any breach of a provision of the PPM or any other agreement made with the investor or any other fund documents.

4.4 Intimation regarding any conflict of interest.

4.5 Risks associated with the portfolio, such as concentration risk, foreign exchange risk, leverage risk, realization risk, strategy risk, reputation risk, extra-financial risks such as social and corporate governance risks etc. at fund and investee company level.

5. Intimation of any non-material changes in the operations of the fund.

5.1 Non-material changes such as

-Bank account details

-Address of AIF or its Manager or Sponsor

-Contact details such as email-id, contact number, etc. of AIF or its Manager or Sponsor

6. Grievance redressal

6.1 Redressal of investor complaints received directly from investors and/ or from SEBI/ SCORES.

D. Timelines of the activity/ services provided to investors:

Sl. No.	Description of activity/ services provided by AIFs to its investors	Timeline for completion of activity
1.	Valuation related disclosures:	
a.	Valuation of investment by Category I and II Alternative Investment Fund	At least once every 6 months. Can be extended to once a year with approval of 75% of its investors by value of investment.

b.	Disclosure of NAV of scheme(s) of the Category III Alternative Investment Fund	Close ended fund - quarterly basis Open ended fund - monthly basis
2.	Transparency related disclosures:	
a.	Disclosure of financial information of investee Companies	Category I and II – within 180 days from the year end or earlier as per the fund documents. • Category III – within 60 days from the end of the quarter end or earlier as per the fund documents.
b.	Disclosure of Material risks: concentration risk, foreign exchange risk at fund level and leverage risk, realization risk, strategy risk, reputation risk at investee company level, extra-financial risks such as social and corporate governance risks etc. at fund and investee company level	
c.	Financial, risk management, operational, portfolio, and transactional information regarding fund investments	To be disclosed periodically to the investors
d.	Any fees ascribed to the Manager or Sponsor; and any fees charged to the Alternative Investment Fund or any investee company	
e.	Any inquiries/ legal actions by legal or regulatory bodies in any jurisdiction	As and when occurred
f.	Any material liability arising during the Alternative Investment Fund's tenure	
g.	Any breach of a provision of the placement memorandum or agreement made with the investor or any other fund documents	
h.	Intimation regarding conflict of interest in any transaction	As and when they arise or seem likely to arise
i.	Any change in terms of Private Placement Memorandum/ fund documents	On consolidated basis within 1 month of end of each financial year

3.	Complaint handling related services:	
a.	Response to complaint received from investors	Within 30 days from the date of receipt of complaint
b.	Redressal of investor complaint received from SEBI/ SCORES	Within 30 days from the date of receipt of complaint

E. Details of grievance redressal mechanism and how to access it.

1. Alternative Investment Funds are required to redress all investor complaints in timely manner.
2. An Alternative Investment Fund, by itself or through the Manager or Sponsor, are required to lay down procedure for resolution of disputes between the investors and AIF or Manager or Sponsor through arbitration or any such mechanism as mutually decided between the investors and the Alternative Investment Fund.
3. Investors can also approach SEBI for redressal of their complaints through SEBI SCORES platform. On receipt of complaints SEBI takes up the matter with the concerned AIF.
4. Investors may send their complaints to: Office of Investor Assistance and Education, Securities and Exchange Board of India, SEBI Bhavan. Plot No. C4-A, 'G' Block, Bandra-Kurla Complex, Bandra (E), Mumbai - 400 051.

F. Responsibilities of investors

1. Responsibility to inform and educate yourself

- 1.1 Read thoroughly all fund documents including Private Placement Memorandum, Contribution Agreement, sales literature, newsletters and understand the product.
- 1.2 Carefully consider all investment risks, fees, and/or other factors detailed in these documents.
- 1.3 Ensure and make certain that the proposed investment in the Fund meets your investment objective and is in alignment with your risk appetite.
- 1.4 Review your portfolio holdings, account statements and transaction confirmation on regular basis to ensure that you aware of all transactions and securities where you are invested.

2. Responsibility to timely update your KYC and information with the Intermediary

- 2.1 Provide complete and accurate information in your KYC documents, including financial/ income status.
- 2.2 Timely updation of KYC information.

3. Responsibility to abide by the contribution agreement.

- 3.1 The investor needs to read carefully and understand the agreement that he/she is entering into with the Alternative Investment Fund and abide by the terms thereof.
- 3.2 The investor should be aware that investment terms are not guarantee of future performance or returns of the Fund/ Scheme.

4. Responsibility to use right financial intermediaries, consultants and advisors.

4.1 Carefully consider validity and reliability of investment information obtained from all sources, especially unsolicited information obtained over the Internet.

5. Responsibility to maintain confidentiality of information.

Investors shall not disclose any material non-public information that is received by virtue of being investors of the fund, except as may be guided by the terms of the fund documents.

Sample Questions: Chapter 8

1. One of the key disclosures in a Private Placement Memorandum (PPM) is:

- a. the amount of investment made by the investor
- b. the management fee structure**
- c. the details of asset securities
- d. the minimum guaranteed return

2. Investment objective of AIF refers to _____.

- a. reporting requirements
- b. Target TVPI
- c. investee company performance
- d. identification of investment opportunities**

3. One of the following is a key risk factor for an AIF investor:

- a. Regulatory risk of the AIF industry**
- b. Demand-supply gap
- c. Personal tax structure of the investor
- d. Data privacy of the sponsor

4. Minimum PPM disclosure standards prescribed by SEBI are not applicable to angel funds. State whether True or False.

- a. True**
- b. False

5. SEBI has prescribed minimum disclosure standards for a PPM to ensure guaranteed return by all AIF funds. State whether True or False.

- a. True
- b. False**

Section C: Managing AIF Investments – Category I and II AIFs

CHAPTER 9: INVESTMENT STRATEGIES

LEARNING OBJECTIVES:

After studying this chapter, you should know about:

- Various Investment Strategies for Category I and II AIFs

9.1 Investment Strategies used by Category I and II AIFs

Category I AIFs and Category II AIFs are primarily investing in unlisted and high-growth companies, which include early-stage start-ups, small and medium enterprises, infrastructure companies or companies planning to issue shares through an Initial Public Offering.

In order to understand the investment strategies used by Category I AIFs and Category II AIFs, let us understand the stages at which any company would typically require funding and how do these company raise funds:

9.1.1 Stages of Fund-Raising for a Young Company:

1. Pre-seed Capital:

Pre-seed capital is provided to entrepreneurs or start-up founders to help them develop an idea. At this stage, the entrepreneurs identify a problem statement and develop an innovative solution to solve the problem. To ensure that the idea is validated, the entrepreneurs also seek support from start-up incubators which provide them the required mentorships and connect with early-stage investors. The capital raised at this stage is invested to validate the idea and ensure that the idea is sustainable, scalable and saleable. Since the entrepreneurs only have an idea and not ongoing revenue, it becomes difficult to raise the initial investment from banks and investors. Investors at this stage are Family and Friends.

2. Seed capital

Seed capital is the capital provided to help the entrepreneur develop their idea into an early-stage product. This is the stage at which the idea is validated, and the entrepreneur is willing to develop the innovative product/service offering, for selling it to potential customers. To ensure that customers like the product, the entrepreneur will be required to do necessary research and development (R&D) to identify the right product segment, market segments,

customer profiles, enabling the entrepreneur to develop the initial product offering. At this stage also, banks and investors would be hesitant to invest in the company, as there are no revenues and profits.

After initial research, some entrepreneurs might receive a positive response from the market test-runs or initial customer feedbacks, based on their break-through products/service offerings. Hence, if a customer liked the product/service offerings, paid for the same and is willing to pay for it once again, then the entrepreneur has said to achieve “Product Market Fit”. At this stage, high net-worth individuals called “Angel Investors” would be willing to take the risk and invest in such product offerings in anticipation of growth. Generally, investors prefer investing through hybrid securities such as Convertible Debentures or Convertible Preference Shares, as it gives a fixed income flow for the initial years, especially in the first 3 to 5 years of the company; and also provides the benefit of equity-shareholding in the long term. Investors at this stage are High Networth Individuals (HNIs), Angel Investors or Angel Funds.

3. Early-stage capital

Early-stage capital is the capital provided to set up initial operation and basic production, as the company can get customers for their offering to help generate revenue. Early-stage capital supports product development, digital marketing, commercial manufacturing and initial customer outreach.

As the company starts generating revenues, it can raise funds from Venture Capital investors by issuing equity shares in a Pre-Series A, Series A or Series B round, or it can raise debt-funding from Venture Debt funds. Again, investors prefer investing through hybrid securities such as Convertible Debentures or Convertible Preference Shares, as it gives a fixed income flow for the initial years, especially in the first 3 to 5 years of the company; and also provides the benefit of equity-shareholding in the long term. At this stage, investors such as friends, family and early-stage angel investors, who invested in Stage 1 and Stage 2 funding, exit the company. This helps them to realize their profits by selling their holdings to new investors in the “Secondaries” market.

Some companies may require short-term financing to fund their working capital requirements between two rounds of funding. This is known as a “Bridge Round”. Banks, Debt Funds or even Venture Capital Funds provide such working capital funds. Investors at this stage are Venture Capital Funds, Debt Funds, Venture Debt Funds etc.

4. Later-stage capital

Later-stage capital is the capital provided in order to scale the business and expand in different markets, geographies, develop new product segments or acquire companies in

order to increase their product offerings. This helps the company to increase their revenue and grow in scale.

This stage starts from raising Series C funds, in order to invest in product improvement, large-scale marketing campaigns, new acquisitions and launching new products. A company can raise funds through Series D, E, F and further rounds, till it announces its IPO and gets listed on a stock exchange. If the company does not wish to get listed, it may continue to raise funds from the private markets and also reach out to institutional investors, such as banks, insurance companies and mutual funds. At this junction, the initial angel investors and venture capital funds exit the company to realize their profits. Investors at this stage are Private Equity Funds, Institutional Investors etc.

5. Mezzanine Round

Mezzanine Round is required when the company wants to get listed on the stock exchange and requires funds to complete the listing formalities, such as appointing merchant bankers, legal counsels, auditors, registrar and transfer agents, among others. Investors include anchor investors who are allotted shares at a reasonable discount to the Issue Price of shares in the IPO. This Pre-IPO round of investment also provides an opportunity for employees having Employee Stock Option Plans (ESOPs) to exercise their option and sell shares to new investors in the company. Alternatively, the company may look at raising funds by issuing hybrid instruments such as convertible debentures or convertible preference shares. Investors at this stage are Anchor Investors, Institutional Investors, Retail Investors.

The stages at which a company raises funds may differ from industry to industry, based on the industry dynamics and execution plan of the management team. The above stages are representative of the life-cycle of the company, when it would typically require funding.

9.1.2 Investment Strategies

1. Angel Investments

Angel Investments are made at the initial stages, generally Stage 1 and Stage 2 of a company's life cycle, as discussed above. Essentially angel investors are high net worth individuals (HNIs) who invest in their individual capacity or through their family offices with own funds. In most situations, start-up ventures find it difficult to establish the required confidence for Venture Capital funds to invest or banks to lend to them. Therefore, angels take the high risk and address the critical financing gap in the initial formative phase of a start-up business venture.

Angel investors primarily look at the potential growth of the start-up's business idea, along with the team who will execute the business idea. When investing in nascent stages, the investors may not know whether the idea will sustain and scale-up. At this stage, they are simply seeing the team's capabilities and experience which would ensure that the business scales. Angel investors will look at the Customer Acquisition Cost (CAC) and the Customer Lifetime Value (CLV) of the start-up. This measures that how much is the start-up spending per customer, to get its revenue from that person. If the CAC is very high, there are high chances that the start-up would not be able to make profits from its operations.

In India, the failure rate of start-ups is 90%, while 80% of start-ups fail in the first five years.⁷⁴ On account of such high risk, angel investors prefer to have a portfolio of minimum 10 companies, out of which they expect 1 or 2 companies to give exponential growth and Net Return on Investments, after averaging the losses in other companies.

Angel Investing platforms have also gained popularity, wherein a group of small angel investors can pool in capital and form a syndicate, to invest collectively in a start-up. Some angel investors may have the capacity and willingness to make higher ticket sizes of investments, upwards of INR 25 lakh in one start-up, while small investors may want to invest not more than INR 5 lakh or INR 10 lakh in one start-up. By investing through syndicates, angel investors can invest in a diverse portfolio of start-ups or early-stage companies.

2. Venture Capital (VC) Investments

Venture capital can be termed as the first stage of institutional financing in an early-stage company or start-up, generally after the angel funds are successfully raised by such company or start-up. Venture Capitalists are always on investing in asset-light businesses that are intensive in technology, intellectual property or digital media applications.

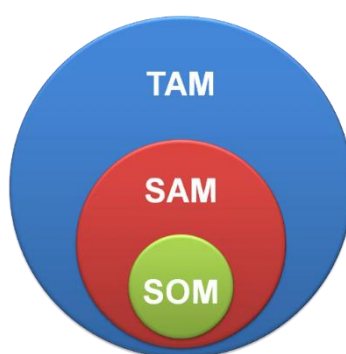
The SEBI (Alternative Investment Funds) Regulations state that VC investments should be made in companies offering new products, new services, technology or intellectual property-based activities or a new business model. These nascent ventures show high potential to grow into large businesses or start to demonstrate growth at a very high growth rate year on year. Venture capital investments are therefore considered highly risky and rank as such among alternative investments.

Venture Capital investors invest in revenue-generating companies, as compared to Angel investors who invest their money on the Founding Team at the idea stage. Venture capital investors look at metrics like Monthly Run Rate (MRR) or Annual Run Rate (ARR), to gauge the consistency and sustainability of revenue generated by the investee companies. Venture

⁷⁴<https://startuptalky.com/startup-failure-success-rates-statistics/>

Capital investors are also very cautious while investing in companies with a high Customer Acquisition Cost, as this can hamper long-term growth and sustainability of the investee company. At this stage, great emphasis is also given to study the direct and indirect competitors of the investee company.

Presence of competition is a good sign for investors as it proves as a validation of a high Total Addressable Market (TAM) for the investor. If the market size is big and demand for the company's offerings is growing, the investors will always show keen interest and focus their research on the ability of the founding team to execute the business model. This is captured by a metric called as Serviceable Available Market (SAM), which measures how much TAM can be realistically achieved by the investee company, based on its business model and revenue targets. The investors then actively look at the Serviceable Obtainable Market (SOM), which is percentage of the SAM that can be captured in the long run, with a sustainable marketing approach. Valuation of an investee company at this stage depends on high value of the SOM for the company.



3. Private Equity Investments

PE Fund means “an AIF which invests primarily in equity or equity linked instruments or partnership interests of investee companies according to the stated objective of the fund”.⁷⁵ It may be understood that private equity fund is primarily an equity-based investor but unlike venture capital funds which are focussed on early-stage investments, private equity funds are mostly involved in later stage financing in business entities that have established a business model and need to be scaled up for further growth.

The term ‘private equity’ (PE) has wider import and is a generic term used for direct investments in companies that are not listed on a stock exchange. Typically, PE investments are made into mature businesses in traditional industries in exchange for equity, or ownership stake. Growth investing is a common PE strategy, wherein an investor will acquire a minority stake, looking to further grow the company. These investments typically take

⁷⁵Equity linked instruments include instruments convertible into equity shares or share warrants, preference shares, debentures compulsorily or optionally convertible into equity.

place at the intersection of VC and PE, where companies are still growing but may have already shown some profitability. Generally, Private Equity Funds prefer to have a board seat on the investee companies and not dilute their shareholding on account of further fund-raising.

4. Syndication

Syndicates enable many small investors to pool their funds in a “Special Purpose Vehicle” and participate in an investment with other reputable and big ticket-size investors. The Special Purpose Vehicle makes a single investment in the target company, by subscribing to the equity shares, although the money is pooled from various investors. There are several platforms offering Syndicate services.

To initiate the process of syndication, there is a “Lead Investor” who gets high-risk, high return deal to invest in a potential start-up. Before syndication of funds happen, such Lead Investor ensures that thorough due diligence is done on the company, including Financial Due Diligence, Business Due Diligence, Operation Due Diligence and Technological Due Diligence. Once the Lead Investor is convinced that the start-up has growth potential, such investor will create a Syndicate and commit capital, to ensure skin-in-the-game. Once the syndicate is listed on the investment platform, the Lead Investor can start approaching other potential investors who are willing to co-invest.

As per SEBI (Alternative Investment Funds) Regulations, only Accredited Investors are permitted to invest in the syndicate deals. Hence, the lead investor will be required to ensure every investor is in compliance with the Accredited Investor Framework, as specified by SEBI. The Lead Investors generally charges a fee from syndicate investors, to compensate for their efforts of due diligence and deal scouting. This fees can vary across deals and investors. Some Lead Investors may charge a one-time fees, while others may take a share in the profits earned by the Syndicate, like Carried Interest.

For example, Mr. A is a lead investor who wants to raise INR 25 crore for a Pre-series A round for Company XYZ. He created a Syndicate called ABC LLP and committed INR 5 crore himself and has approached other accredited investors who are willing to commit the balance INR 20 crore, with a Carry of 15%. If ABC LLP exits the start-up by selling its stake at INR 75 crore after 3 years, then the Syndicate investors (including Mr. A) will pay 15% of the profit of INR 50 crore to Mr. A and the balance will be distributed to investors on a pro-rata basis, based on their committed capital in the syndicate.

5. Securitized Debt Instruments (SDIs)

Securitized debt instruments are financial securities that are created by securitizing loans (debt) given to companies, listed or to-be-listed debentures and other forms of structured financing such as sub-ordinate debt, working capital loans and mezzanine financing.

Securitization is the process in which certain types of assets are pooled so that they can be repackaged into investable securities with a pre-determined periodic income.

Securitized Debt Instruments can be traded on the stock exchange in India. An SDI is almost similar to a Special Purpose Vehicle (SPV), which is created with the sole intention of pooling funds and investing in assets that can be further leased on to a target company, with an intent to receive periodic lease as well as the scrap value on sale of such assets, after the targeted tenure. The investors pool the money in such SPV with an intent to receive a fixed income from the lease payments, regularly. The target company, especially those which are capital-intensive (such as manufacturers of Drones, Electronic Vehicles, Charging Stations, Robots, etc.) can avoid paying interest on loans and directly lease the required assets from the SPV.

The originator, or sponsor, of the SDI is responsible to do due diligence on the target company which takes the assets on lease, to avoid default risk which can impact the investors' return and principal investment. The Sponsor should do its reference checks on the management team of the target company and identify potential red flags in the company's financial statements, key contracts taken, existing lenders, default history, compliance issues, pending litigations, among others. SDIs issued by such sponsor are also rated by credit rating agencies, based on the inherent risk, target companies, assets leased, lease amounts, tenure and returns.

Through an SDI investment, investors can get the benefit of investing in high-growth industries and sectors, while ensuring fixed timely payments with limited risks. SDI was introduced by SEBI in 2008 under the SEBI (Issue and Listing of Securitised Debt Instruments and Security Receipts) Regulations.

6. Leveraged Buy-out

Private equity (PE) also participates in more complex transactions involving control acquisitions (known as 'buyout') and Leveraged Buy Outs (LBOs) which comprise of doing buyouts with significant leverage. An LBO is a buyout where an acquiring company borrows funds to buy the target company, taking on significant debt, which is secured against the target company's assets. LBOs are an attractive option for acquiring companies promising a high return on investment, with a smaller upfront investment. In such transactions, investors typically look to acquire controlling interests of either 51% or more of the share capital or voting rights of a target company.

Leveraged Buyouts are typically done when there is large forecast of cash flows contingent on the unlocking of value from a new project, business plan or corporate restructuring. In such a situation, the investor may take the view to lend against these future lumpy cash

flows but require an adequate return to reflect the additional risk. Through the LBO deal, an investor can take a public company, private. Alternatively, a target company can spin-off an existing business vertical and sell it in the LBO deal.

Management Buyouts (MBOs) are a common form of Leveraged Buyouts, wherein a group led by people in the current management of a company buy out majority of the shares from existing shareholders and take control of the company. For example, company ABC is a listed entity where the management has a 25 per cent holding while the remaining portion is held by public shareholders. In the case of an MBO, the current management will purchase enough shares from the public so that it can end up holding at least 51 per cent of the stock. This strategy is used by management teams who have the expertise to operate the company in future.

9.1.3 Difference between idea and opportunity and the process of deal sourcing

There is a big difference between an idea and an opportunity in business. An idea is a concept that could be used to make money; however, an opportunity has proven commercial value. Knowing the difference between an idea and an opportunity is crucial to avoid wasting significant time and money of the investors, as well as the founders. An idea has the potential to become 'an opportunity' and a viable enterprise, if it has the potential to break even, generally within 36 months from ideation, has a passionate and dedicated team developing the idea, faces manageable risks and can forecast high gross margins.

9.1.3.1 Deal Sourcing for Private Equity Firms

Deal sourcing refers to the process of finding new companies to invest in. Private equity firms invest in private companies that aren't part of the public stock exchange list. Therefore, it's harder to find new opportunities. In private equity deal sourcing, a firm typically analyses at least 40 to 50 investee companies, before making 1 investment. Best practices for Private Equity Deal Sourcing:

Growth monitoring

Growth monitoring can be done through software subscriptions, which provide updated and reliable data on growth-stage companies. Such software provides data on business model, founding team, current investors, revenue model, Annual Run Rate (ARR)⁷⁶, Cash Burn⁷⁷, Product Segments, Market Segments and other key indicators for investors to make their investment decision. Some of the common indicators used to monitor growth are:

- Growth in team size
- Social media presence

⁷⁶ ARR is the yearly equivalent of MRR and represents the predictable revenue generated annually.

⁷⁷ Cash Burn is the rate at which a start-up spends its cash flows for business purpose.

- Revenue growth
- Market Share and Key Competitors
- Experienced Management Team
- Potential to become a leader of the market
- Unit Economics

Liquidity indicators

There are several liquidity indicators that may signal why the company needs funds from a Private Equity investor. Some of them are:

- C-level employees nearing retirement or wanting an Exit, after achieving targeted growth.
- Expansion plans in multiple geographies and appointing a team of distributors.
- Rise of competition and a chance to acquire new players in the market.
- To allow existing Venture Capital or Angel investors to exit

Brand presence

Building a solid brand presence is one of the most important aspects for Private Equity firms. Marketing and PR activities of the investee companies are closely observed by the PE funds. One of the main reasons behind this increase in brand-building rises from competition for the best deals. To build a stronger brand presence, it's important to foster new and existing relationships.

Similarly, start-ups and investee companies may select a PE firm with a stronger brand presence. Early-stage start-ups also prefer to get investors who have the ability and willingness to help the business grow, by giving them the right market access at the right time.

9.1.3.2 Private equity deal structure

The deal pipeline in private equity consists of the following steps:

- **Deal sourcing:** Dedicated professionals help a PE Fund to streamline the process and building lists of potential start-ups from research, emails, calls, and other sources. The start-ups so approached provide investor pitch to the PE Fund.
- **Signing an NDA:** After gaining interest in a start-up, a Private Equity firm will move on to signing a Non-Disclosure Agreement (NDA), so that their team can assess and examine the start-up's records before proceeding.
- **Initial due diligence:** Due diligence process helps to gain a deeper understanding on how the start-up and its management is executing the plan that was pitched to the investor.
- **Investment proposal and non-binding Letter of Intent (LOI):** After successful due diligence, the investors proceed to propose an investment and submit it to the Management Team of the start-up. The Private Equity Fund will provide a non-

binding LOI with their proposed investment amount, start-up valuation and the stake in the company. The amount is usually defined in a range, not a specific value.

- **Term Sheet negotiations:** If the start-up has accepted the letter of intent, they sign on the Term Sheet and a Summary of Principle Terms (SOPT), which lays down the binding and non-binding clauses on both parties. At this stage, the investment has not been made yet in the start-up.
- **Final due diligence:** If the start-up has accepted the letter of intent and signed the term sheet, the Private Equity investor will get access to confidential information about their business and conduct their final due diligence. This includes financial due diligence, business due diligence, technological due diligence, and operational due diligence.
- **Final Investment Memorandum:** Once the investment committee of the PE Fund gives its final approval, they create a Final Investment Memorandum, and the deal team proposes a specific amount of valuation for the acquisition of the company. The start-up can negotiate on the final valuation, before signing the final agreements.
- **Signing the Shareholder Agreement and Share Subscription Agreement:** The Private Equity firm will hand over the cheque, while signing the Shareholder Agreement and Share Subscription Agreement, wherein the investor will be allotted the shares and receive the share certificates. The name of the investor will also appear on the Capitalization Table of the start-up.

Sample Questions: Chapter 9

1. If a company is at the stage of achieving proof of concept (PoC) for its product and is therefore in the seed stage, who among the following can be a potential investor in the company?

- a. Sovereign Wealth Fund
- b. AIF registered as a Category I Fund
- d. High Networth Investor**
- c. SEBI registered Merchant Bank

2. Monthly Run Rate (MRR) or Annual Run Rate (ARR) is a metric used by venture capitalists to determine which of the following factors of an early-stage company?

- a. Direct operating costs
- b. Bills receivable converted into cash
- c. Total cash outflow or cash burn
- d. Revenue generated from its business operations**

3. Which of the following describes a securitised debt instrument?

- a. It is a debt instrument which is based on leased rentals.
- b. It is a debt instrument created through a pooling of receivables in a special purpose vehicle.**
- c. It is a debt instrument which is fully secured.
- d. It is a debt instrument which has a claim on the cash flows of a bank or a NBFC.

4. Private equity investment is about investing in any potential sector while venture capital investment is about investing in high technology companies.

- a. True
- b. False**

5. In an LBO, the acquirer looks for majority control of the target company so as to ensure upside potential in the deal by growing the target company's value.

- a. True**
- b. False

CHAPTER 10: INVESTMENT PROCESS AND GOVERNANCE OF FUNDS

LEARNING OBJECTIVES:

After studying this chapter, you should know about:

- Stages of Investment process
- Investor Due Diligence
- Investment Committee and Governance standards
- Code of Conduct for Investment Managers and Investment Committee

Investment Process:

10.1 Deal Sourcing

Category I AIFs and Category II AIFs make investments in unlisted companies that show promise for growth and value creation. This is an arduous task as these companies are not easy to find. They are not listed on the stock market, therefore, their presence is somewhat invisible. Secondly, their business and financial details are not available in the public domain as much as in the case of listed companies. In contrast, Category III AIFs essentially invest in listed securities and manage money of High Net-worth Individuals or Institutions. These corporate institutions have a pre-defined methodology for screening a potential investment.

AIF managers need to develop the expertise of identifying companies that can give above-average returns, and zero in on the exact target investment which fits into their investment scheme and return requirements. Managers make use of their extensive network of business and professional contacts, services of investment bankers, consulting firms, deal scouts, investment platforms, practitioners such as auditors and legal firms, other AIF fund managers etc. to develop market intelligence and a database of potential companies that they could work on to generate deal flow.

Sourcing potential deals or good investment opportunities can be difficult and gruelling, but it is an essential skill required to be a fund manager in the AIF industry. Depending on the AIF's preference, a deal may be sourced through a variety of initiatives - internal analysis using a research support team, networking as stated above, appointing deals scouts, co-investing, making visits to various companies, company screens through databases for specific criteria, industry conferences and conversations with industry consultants and experts. One of the key attributes of a successful AIF manager is to be able to showcase an impressive pipeline of deals or investment opportunities to back up their pitch for raising the capital commitments from investors.

10.1.1 Initial Assessment

In addition to developing the deal flow, a lot also depends on how managers evaluate the potential of the companies they identify and the capabilities of the managements of such companies to deliver desired performance. Therefore, the initial assessment is largely about the potential business opportunity presented by the company and the credentials of the key management team (importantly the founders) and whether their vision, competence and drive match the requirements to convert the business opportunity into value creation. Most fund managers will have an investment approach, in which they screen investee companies based on pre-defined criteria, or filters. For example, ABC Category II AIF invests only in FinTech start-ups, who have previously raised funds from a Venture Capital Fund, generate revenues of at least INR 100 crore yearly and the management team has minimum 15 years of experience in Financial Services industry. This approach will limit the investment options and serve as an initial assessment on hundreds of companies approaching them for funding.

Usually, the investment bankers appointed by investee companies send out a ‘teaser’ or a ‘flier’ (a brief 1-3 page summary of the company and the opportunity) to prospective funds after identifying a list of fund managers based on the business sector and investment criteria of the transaction. The fund manager who receives the teaser would need to decide whether a particular proposal has a preliminary fit into their investment philosophy.

If the investment team (investment managers supported by principals, associates and research team in the investment management company) finds the teaser interesting, they will negotiate and sign a Non-disclosure agreement (NDA) to receive the company’s Confidential Information Memorandum (CIM or simply IM) prepared by the investment bankers. In a proprietary-sourced opportunity, investment teams will often sign an NDA directly with the target company to receive some confidential information regarding the company from management. The NDA is especially important to share important technical information and is used extensively as a matter of convention.

Category III AIF managers also conduct an initial assessment, or screening of potential investment opportunities, which is in accordance with the stated investment strategy in the Private Placement Memorandum. The investment strategy can vary based on the marque investors in the fund. Institutions such as Sovereign Wealth Funds, Family Offices will have a different risk-return objective as compared to high-net-worth individuals. The investment manager must consider all the investment constraints also, such as Taxation norms applicable to its investors, any liquidity concerns or funding requirements, regulations and compliances applicable, time horizon of the investment, and such other unique circumstances or macro-economic factors.

10.1.2 Business Due Diligence

At this stage, the investment team will perform some initial business and management due diligence to better understand the potential investee company. This process includes research on the industry, talking to advisors about the current state of the industry and players in it, and building and enhancing a preliminary financial model using the management's projections to understand the potential returns of making the investment. Meetings are also held with the investment bank to hear their thoughts on the financing requirements, type of financing and probable deal structure.

At an appropriate stage the bankers arrange meetings between the investment team and the key management team of the investee company to be able to understand their perspective (known as the 'Management Presentation' or 'Investor Pitch'). The management team will present an overview of the company while the deal team on both sides will be engaged in technical discussions and better picture of the business case, numbers presented, current performance of the company and all associated aspects.

After reviewing the management's presentation and having initial discussions, the investment team will prepare a brief (2-3 page) investment proposal and present it to their Investment Committee.⁷⁸ The meeting can either be to alert the Committee on the potential deal or to commence the first stage of a formal approval process whereby an investment team would seek a 'go-ahead' to negotiate the deal. Sometimes, if the deal processing requires an approval on out-of-pocket expenses to be incurred, a 'cost-cover' may also be approved by the Committee. Once this process is completed, the potential deal is processed further and at the appropriate stage, the investment team must decide to engage in deal negotiations with the company and its investment bankers.

Similarly, Category III AIFs also perform their Business Due Diligence, to gauge the market outlook for listed companies. The research team of the Category III AIF typically analyse the data of listed companies and compare the financial ratios to its peers, such as the Price to Book Value Ratio, Price to Earnings Ratio, Industry outlook, company's market share and many similar factors.

10.1.3 Negotiations by Investment Manager

At this stage, further meetings are held to arrive at the refinement of the business plan presented by the investee company's management, fine-tune the investment and roll-out plan as applicable so that there is meeting of minds with the management on the future roadmap of implementation after the financing needs are met. This process is extremely

⁷⁸ Managers of AIF may constitute Investment Committee to approve investment decisions of the AIF, subject to certain conditions. The Investment Committee would consist of senior management of the investment management company and nominated external members and independent professionals.

important as it culminates into an agreement on the final business plan that would become the basis of the investment and the key deliverables from the company.

In parallel, the contours of the deal are also discussed with the investment bankers as well as the finance and regulatory teams of the company. The broad structure of the financing (debt/equity/mezzanine) are discussed and the appropriate regulatory framework at a broad level is also examined. The investment managers should also get a feel of the company's valuation expectations and to what extent it is negotiable.

10.1.4 Preliminary Investment Memorandum and Term Sheet

Before proceeding to execute the term sheet, depending upon the protocols in the organisation structure of the investment manager, a Preliminary Investment Memorandum (PIM) may be presented to the Investment Committee detailing the proposed investment and deal structure in order to get an authorisation to sign the term sheet.

The investment team presents the potential investee company with a non-binding Letter of Intent (LOI) also called the 'term sheet'. This document is also sometimes referred to as Summary of Principal Terms (SOPT). The offer will detail a proposed transaction, investment amount (often a valuation range is given, rather than a specified amount), a proposed capital structure post-acquisition, board seat, key investor rights and management terms, exclusivity period, conditions precedent to investment and other residual matters. It may be noted that a term sheet is a non-binding document on both the parties and does not provide for any contractual rights whatsoever. It has a validity period within which the parties are expected to complete the transaction and the due diligence process. The validity period is usually extendable by mutual consent if required. The role of the term sheet is to define the modalities avoiding vagueness and injecting precision into the transaction. It would also establish commitment from both sides (due to the exclusivity in the transaction) so that the transaction may be concluded expeditiously in the mutual interest.

10.1.5 Thematic Investing, Portfolio Management and Asset Diversification

Thematic investing is an investing method where the investment manager will identify significant investment opportunities or invest in popular trends without extensive research on individual stocks. For instance, with the development of electric vehicles and government's boost to this industry in India, the investment manager knows that electronic vehicles (EV) will have a strong growth in the coming years. With this investment philosophy, the investment manager can choose to invest in a theme designed explicitly with that view and start investing in start-ups, early-stage venture and even large companies which are directly or indirectly working in the EV industry. This may include EV trucks, EV bikes, charging stations, battery swapping, and such other areas within the EV industry.

Thematic investing is all about emerging opportunities and structural shifts that can offer better returns. This ensures that investors have efficient equity portfolios and enables them to invest in different and specialized sectors with a high growth potential. After selecting innovative and emerging themes (like EV industry), the investment manager can research on the relative returns from the industry, as compared to other asset classes available for investing. This ensures that the investment manager is aiming at returns above the fund's opportunity cost.

By using Thematic Investing, investment managers can manage their portfolio risk and diversify across different industry segments, during different economic cycles. For example, COVID-19 led to the growth of tech-enabled start-ups and companies, especially in Agri-Tech, EdTech, FinTech, Clean Energy, Robotics, among others. Since these industries are not highly correlated, with all of them offering growth potential, the investment manager can allocate the portfolio of an AIF in a manner that companies across all the selected industries can be funded. The weights to every industry can depend on the risk-return objective of the AIF. Thematic Investing not only benefits the investors in the fund, but also the economic development of a nation with growth in emerging technologies.

Governance of Funds:

10.2 Investor Due Diligence

Investor Due Diligence (IDD), sometimes known as 'due diligence review' or 'DDR' refers to the due diligence to be performed by the AIF's investment manager on the potential investee company before firming up the investment. The due diligence process does not commence unless the term sheet is executed by both parties.

In the context of AIF investments, the IDD consists of a comprehensive examination into the facts, representations and affairs of the company by the AIF investment manager so as to take an informed investment decision. Normally, based on the coverage, an IDD or DDR can be broken down into the following components – (a) Business, Commercial and Technical DDR, (b) Financial DDR and (c) Legal DDR. The business and technical DDR is normally carried out by the investment team itself due to their in-house expertise and industry network. Sometimes they may engage technical experts to validate the findings or evaluate the technology if it is very specialised.

The investee company begins the process by providing more detailed confidential information in what is typically referred to as a 'virtual data room' to the investment team. Examples of data room records include constitutional documents such as memorandum and articles, board minutes and reports, books of account, tax returns, invoices, purchase orders, payroll statements, statutory filings, owned and leased property agreements, intellectual property documentation, employee lists and employment agreements, detailed segment financial information, and historical audited financials. The IDD teams usually draw up a

schedule in consultation with the investee company's officials to conduct further discussions.

Follow-up due diligence calls are held (through the supervision of the investment bankers) with specific members of the executive and non-executive management team. Also, based on the data room files, the deal team starts brainstorming the critical issues that they often require to fine-tuning the deal structure or conditions precedent.

Financial DD covers the entire gamut of verification of books of account, financial statements and business transactions of the company with a view to determine the true and fair view of the accounts and financial statements, accuracy of the oral or written representations made by the company in its Information Memorandum (IM) and other literature, material financial information that is not disclosed and which may have a bearing on the investment decision or the agreed valuation and incidental matters. Therefore, a financial DDR almost amounts to a financial review of the company and is usually carried out for the past three financial years at least. In many cases, the scope of work may include vetting of the financial forecast of the company as represented in the IM and the consequent financial milestones. Financial DDR also covers the tax matters of the company, both direct and indirect. The IDD team examines the tax records, filings and assessments of the company and determines if there are potential threats that could lead to impending or future tax demands on the company including legal proceedings. The Financial DDR is usually carried out on behalf of the AIF's manager by an accounting firm or an investment bank engaged by such investor.

Legal DDR is normally conducted by a law firm practising in corporate law and transaction matters. The scope of legal DDR is to determine the legal aspects of the company's business, its Intellectual Property Rights (IPR) protection, its contractual relationships with third parties, material contracts and agreements entered into by the company and their legal implications, outstanding litigation if any and its possible outcomes, statutory compliance under various laws and defaults if any. Sometimes, DDR relating to compliance aspects may be covered under Financial DDR or conducted by a practising company secretary.

The IDD results in the investment manager being presented with confidential reports by the agency conducting the DDR. A copy of the DDR report is generally not made available to the company. However, where necessary, an extract of such report may be sent to the company for suitable clarifications or explanations. Sometimes, based on the IDD, the investment manager prepares a separate observation list and sends it to the company for responses and discussions.

Based on the due diligence report, the investment team start refining the financial model for the investee company based on forecast assumptions that are more realistic in the light of IDD findings. The financial model now presents a very detailed revenue and cost breakdown that is based on specific drivers and assumptions (e.g. price, volume, raw material costs, number of branches, number of customers, renewal rates, fixed vs. variable cost structure, etc.). All of these breakdowns combine into one model to describe the expected financial performance of the company in great detail. This gives the investment manager a complete idea of how to fix key deliverables on the investee company, how to

drive deal performance and maximise potential returns from the investment. Many a time, this could lead to re-negotiations to modify and arrive at the final term sheet that could involve revision in valuation or disclosure statements, strengthening of the representation and warranties from the founders / shareholders / key management team. The final term sheet as executed once again between the parties becomes the basis for legal documentation.

10.3 Definitive Agreements

The term ‘definitive agreements’ is given to the set of binding agreements signed between the investee company and the investment manager representing the AIF to complete the investment transaction. Investment agreements consist inter alia of the following main contracts:

1. Share Subscription/Purchase Agreement <i>(to be entered into between the AIF and the investee company)</i>	This agreement is the main transaction document that is executed in equity financing or investments wherein a new issue of shares by the company is required. The purpose of this Agreement is to detail the terms subject to which such financing/ investment is made by the AIF and provide for rights superior to those of an ordinary investor under the Companies Act as may be required.
2. Shareholders’ Agreement <i>(to be entered into between all the existing shareholders of the company and the AIF. The company is made a party to it if there are clauses that provide privity of contract with the company)</i>	This is an inter-se agreement among shareholders which is intended to make them agree to the rights and obligation stipulated under the agreement. The necessity for this agreement arises as equity investment conditions specified in the share subscription agreement are binding only on the company and not on its shareholders since they are not a party to it. In some cases, where the promoter owns all the shares or has control on other shareholders, a combined share subscription agreement may be entered into incorporating the provisions of a shareholders’ agreement as well.

The share subscription agreement shall also contain provisions relating to reconstitution of the board of the company by appointment of the AIF’s nominees, vacation of office if required, by existing directors, other key appointments if any and other such provisions as determined by the term sheet. Similarly, there could be requirements relating to appointment of managing director for a renewed term under new terms of appointment. There would also be clauses to outline several procedural requirements to accomplish the steps related to the implementation of the aforesaid provisions.

The main purpose of the shareholders' agreement on the other hand, is to bind all the existing shareholders to the conditions stipulated in the agreement. However, if there is an existing shareholders' agreement, care has to be taken to ensure that there are no multiple shareholders' agreements with conflicting provisions. In such case, all the existing agreements will have to be amended to bring all shareholders on common footing. Usually, the latest agreement with all shareholder signatures would supersede all previous ones.

Associated legal documentation for the transaction may include management contracts with key management team of the investee company, additional financing agreements if any, undertakings or declarations from founders/ principal shareholders etc. The articles of association (AOA) of the investee company are amended to incorporate the provisions of the new shareholders' agreement so that it is enforceable.

10.4 Investor Protection Rights in Category I and II AIFs

10.4.1 Milestone Valuation

Quite often, venture capital investors will not wish to agree to a valuation based on future forecast at the time of investment since they don't know when the company would achieve profitability. Instead, they peg the valuation to technical and/or commercial targets (milestones) being met. These milestones will be set out in the business plan. Failure to meet a milestone does not automatically mean that the investors will not provide the investment, but it may mean that it could lead to a downward revision in the valuation or a 'downround' of follow-on investment or delay in future investments.⁷⁹

10.4.2 Dividend Rights

Investor may stipulate a prohibition on the payment of any dividend to the equity shareholders, especially the Founders, which may be for a limited period of time. Even if the payment of a dividend is permitted, a common way of ensuring that a company is not obliged to pay dividends while it is growing is to provide the investors with a preferential right to dividend through the issue of preference shares with a cumulative right so that the company can pay it out when it has sufficient liquidity.⁸⁰ It may also be provided that the dividend accumulates and would be paid out as additional shares through a bonus issue (stock dividend), or converting the preference shares to equity shares at a favourable valuation to the investor. The company may also be prevented from declaring any dividend without the

⁷⁹A 'downround' refers to a particular financing round in which the valuation of the company is less than what it was in the previous round of financing. Downround may happen due to adverse performance by the company and / or due to external factors that may reduce investor confidence in the company.

⁸⁰Preference shares may be issued by a company as provided under section 43 of the Companies Act 2013. They carry a first right to receive dividends and to receive repayment of capital on winding up of a company.

concurrence of the investor by providing them with an overriding right to veto the payment of any dividend. In addition, it may even be stipulated that the promoters are obliged to reinvest the dividend received as equity in the company on pre-agreed terms.

10.4.3 Anti-Dilution Rights

One of the most common type of anti-dilution rights is the 'pre-emptive right' of a shareholder which enables him to maintain his percentage of shareholding in the company by having the right to participate and purchase pro-rata shares issued by the company in future rounds of financing or stock options being exercised by their owners. This right is typically associated with Convertible Preference Shares. An anti-dilution clause grants an investor the right to convert their preferred shares at equity shares, at a revised price and conversion ratio. To compute the new issue price and conversion ratio, there are two methods used, namely Full Ratchet and Weighted Average. A pre-emptive right however, is only a right and not an obligation of the shareholder to invest in future round of financing.

In the context of VC deals since investments are made in early stages, the investor looks for downside protection first and returns later. One of the main risks in such investments is the risk of 'over-valuation' of the company if the valuation model is mostly contingent upon future growth parameters. Therefore, it is common to find that this risk is addressed more stringently in VC deals.

The basic principle on which the ratchet operates is that in the event there is a 'down round' subsequent to the investor's investment, the investor will be compensated by converting the preference shares into equity shares at the lowest issue price by the company.

Example: Start-up XYZ has 1,00,000 Equity shares outstanding, priced at INR 10 each. It raises Angel funding and issues 30,000 preference shares, at INR 10 each, with a Conversion Ratio of 1:1 at INR10 per share. Angel Investors have Anti-Dilution Right. Now the Start-up later raises Pre-Series A Funding and issues 25,000 shares at INR 6 each.

In this example, the Angel Investors can exercise the Anti-dilution right. Through this right, they will be issued further shares in the company, as the new shares were issued at INR 6 each. The Conversion Ratio of 1:1 was computed using a fair market value of INR 10 each. With the revised price of INR 6 per share, the angel investors should hold 40,000 shares of the company. Additional 10,000 shares of the company will be issued to the angel investors without any consideration.

Full Ratchets can be complicated in operation and need to be very carefully thought through due to tax and regulatory issues and in order to avoid conflicts of interest between the founders, the company and its other shareholders at a later date.

In the weighted average method, the new conversion price is calculated using the ratio of the total consideration received from all issues and the total number of shares issued till date. This new conversion price will be used to compute the revised conversion ratio.

Continuing with the previous example, Angel Investors were issued preference shares with a conversion price of INR 10 each. Total amount of capital raised by the company includes the initial equity share capital of INR 10 lakh plus INR 3 lakh raised from Angel investors plus INR 1.50 lakh raised from Pre-series A investors. Total amount of capital is Rs 14.50 lakh and total number of shares issued is 1.55 lakh shares. Hence the new conversion rate will be calculated as follows:

New Conversion Price = $(14.50 \text{ lakh} / 1.55 \text{ lakh}) = \text{INR } 9.355$

Using the new conversion price of the INR 9.355, the conversion ratio will be revised as under:

$10 / 9.355 = 1.069 \text{ shares}$

Therefore, 1.069 equity shares will be issued, instead of 1 equity share, when the preference shares will be converted to equity shares.

The full ratchet method will always be more beneficial to owners of preferred shares, as it grants them the right to convert at the lowest available price. The weighted average method will help protect some of the value of their preferred shares.

10.4.4 Affirmative and Veto Rights and Voting Rights

In order, for startup investors, to have a say in the company's management, they need to be able to vote on decisions that affect the company. Hence, every startup investor is given voting rights, to express their opinion on an important management decision, which may have an impact on their investment. Startup investors should negotiate affirmative rights and veto rights in the term sheet.

Affirmative rights are those corporate actions that require the approval of the investors irrespective of the extent of their shareholding in the company. In other words, even if a particular action can be accomplished through an ordinary resolution (simple majority of 51%), an affirmative right will mean that such business cannot be carried through without such shareholder's express consent. Affirmative rights are viewed as 'positive control', i.e. the power to influence corporate actions, and they create an obligation on part on the promoters and company to seek prior approval from investors before taking decisions on matters covered under affirmative rights. Some of the standard matters on which affirmative rights are insisted by investors are the following:

1. Changes in the capital structure of the company by new issue of shares through preferential allotments or otherwise or a buyback of existing shares. The restriction on new issues is also known as a 'pre-emption right' on future capital issuances.
2. Alteration of the Memorandum and Articles of association.
3. Raising of secured debt or issuance of debt securities in excess of agreed limits.
4. Any type of new fund raising except renewal or enhancement of normal working capital limits.
5. Proposal to make an IPO or indirect listing or listing of debt instruments.
6. Making any investments other than in the ordinary course of business.
7. Any change in the business plan or activities of the company.
8. Spinning off or starting subsidiaries or divesting in them.
9. Any scheme or decision for a rearrangement, reconstitution, merger or amalgamation of the company.
10. The conveyance or other disposition of the assets of the company the value of the assets being in excess of an agreed value which are not in the Ordinary Course of Business.
11. The suspension or discontinuance of business activities of the company.
12. Any action to initiate winding up of the company.
13. Changes in the constitution of the board by appointment of new directors.
14. Changes in the senior team members of the Company.
15. Creation or Alternation in the Employee Stock Options (ESOP Pools)
16. Appointment or removal of the auditors of the company.
17. Appointments, terminations and changes in the service conditions of employees comprising the key managerial personnel.

In contrast with affirmative rights, a veto right is to oppose a corporate action even if it has the requisite majority. It is also known as 'negative control' or the right of an investor to say no more as a defence to protect his own interests. Veto powers are insisted upon by investors in some of the corporate actions listed above as an alternative to affirmative rights. For e.g. the full ratchet clause can be used even through a veto power on further issuances of shares by the company so as to protect dilution of the investor's equity in a down round.

10.4.5 Liquidation Preference

'Liquidation preference' is a right which can be required by the investor in recognition of the risk it bears on its capital contribution. While there are many variations, the liquidation preference typically provides that, in the event the company is liquidated or subject to liquidation, the preferred shareholders will receive a certain amount of the proceeds in priority before any other shareholders, including the founders. This preference amount may be equal to the amount of the preferred shareholders' investment, or a multiple of it applied

in different complex combinations. The size and structure of the liquidation preference will be negotiated to reflect the risk inherent in each investment round, i.e. higher the risk, higher the required return. Liquidation Preference is triggered on the happening of events like sale of shares or substantial assets, an acquisition or merger of the company, consolidation, merger, amalgamation or demerger.

Participating Liquidation, or double-dip liquidity preference goes a step ahead from the multiples mechanism to secure the interest of the investor. In addition to the Guaranteed Return equal to the liquidation preference multiple, the investor receives participation rights to share the remaining proceeds in proportion to the shares held by the investor. However, in a Non-Participating Liquidation, the investor received either the Guaranteed Return equal to the liquidation preference multiple, or the participation rights to share the remaining proceeds in proportion to the shares held by the investor.

Example of Non-Participating Liquidation:

VC Fund ABC invested USD 1 million in convertible preference shares of a start-up for a 10% stake, with a 2.0x liquidation multiple. If the start-up is acquired for USD 50 million after 2 years, VC Fund ABC will choose to either receive:

- USD 2 million based on their liquidation preference, i.e. 2 times their investment, OR
- Converting their preference shares into equity and receive USD 5 million on sale of its 10% stake in the company, which is sold for USD 50 million.

Example of Participating Liquidation:

VC Fund ABC invested USD 1 million in convertible preference shares of a start-up for a 10% stake, with a 2.0x liquidation multiple. If the start-up is acquired for USD 50 million after 2 years, VC Fund ABC will receive USD 2 million based on their liquidation preference and then share in the remainder alongside the common stockholders. Assuming there are no other preference shareholders in the start-up, VC Fund ABC can receive an additional amount of USD 4.8 million, i.e. 10% of the remaining amount of USD 48 million to be distributed to all investors. Hence, the Fund will totally receive USD 6.8 million when they exit the start-up.

10.4.6 Exit Rights

‘Right of First Refusal’ (ROFR) and Right of First Offer (ROFO) - These are contractual terms between shareholders which are provided in the Shareholders’ Agreement. It may be understood that these are arrangements inter-se between shareholders and do not affect the company as such.

If a shareholder wishes to dispose-off shares that are subject to a first right of refusal (ROFR), then such selling shareholder must approach the ROFR-holder with the best quote from market participants. The ROFR-holder may choose to buy shares by matching the best quote, or refuse to buy the shares.

If a shareholder wishes to dispose-off shares that are subject to a first right of offer (ROFO), then such selling shareholder must approach the ROFO-holder and seek his best offer for such shares. After receiving the best quote from the ROFO-holder, the selling shareholder can approach other investors in the market for receiving their offers. In case the selling shareholder gets a lower offer from the market, then such selling shareholder must compulsorily offer the shares to the ROFO-holder at their offered price. In case the selling shareholder gets a higher offer from the market, then such selling shareholder can sell the shares at the best offer price in the market.

The rationale behind a right of first refusal and a right of first offer is that the existing shareholders must be provided with the benefit of increasing their stake in the company before offering such shares to a third party.

‘Co-sale’ and ‘Tag Along Rights’ - In the case of a ‘co-sale’ or ‘tag along’, if a shareholder wishes to dispose off shares that are the subject of such a right, the other shareholders who benefit from the right can insist that the potential purchaser agrees to purchase an equivalent percentage of their shares, at the same price and under the same terms and conditions. The rationale for this right is to have the effect of making the shares more difficult to sell. This is because, the AIF investors often bank on the strength of the technical and management experience of the founders and management. Therefore, they do not want these individuals to reduce their stakes or exit the company while they remain invested. Usually, the right of first refusal and tag along right are provided for simultaneously on the shares held by the promoters and key managers. In addition, investors may sometimes require a lock-in on such shares for a specified period.

‘Drag Along Rights’ - A ‘drag along’ right (sometimes referred to as *‘bring along’*), creates an obligation on the other shareholders of the company (subject to such right), to sell their shares to a potential purchaser if the shareholder with such right chooses to sell to that buyer. For e.g. the AIF investor may have a drag along right on the promoters. Therefore, if it wishes to exit, the promoters will be obliged to sell to the same buyer on the same terms. A drag along is usually insisted when the AIF is a minority investor in the investee company. The objective is to drag the promoters along so that the stake that can be offered to the buyer would be large enough to attract a control or strategic premium thereby optimising the exit for the investor. In the absence of this right, sale of a minority stake could be difficult and sub-optimal due to minority or non-marketability discount.

10.4.7 Extent of Option Pool

An option pool is created to assign stock options to employees or stakeholders in the company. Stock options are used as an effective mechanism to offer shares of the company to an employee if the employee fulfils certain pre-defined conditions. If the employee fails to meet the pre-defined conditions, the options lapse without any share allocation. Allowing an employee to share ownership in your company can be an excellent way of aligning their

interests and inspiring them for future. The Stock Options can be provided based on the revenue targets, technical achievements, or scale of growth of a company.

Extent of an option pool created by every company or start-up is critical to its investors, as it directly impacts their ability to invest in the same company. If employees exercise their stock options, it may potentially result in dilution of an investor's stake in the company as well. The Extent of option pool depends on various factors such as the stage of the company, collective strength and skills of the team, revenue targets, growth expectation and most importantly, lack of initial funding to pay employee salaries. An option pool of 15% of the total capital means that all employees in the company can potentially own 15% of the company if they are able to satisfy the above-mentioned conditions. Within this pool, different level of employees are offered different stake in the company. For example, a Chief Marketing Officer may be given stock options of 3%, while a Chief Technology Officer may be given stock options of 2%. Again, these numbers are not fixed and may vary from company to company as well. It also depends on the importance of that employee in scaling the start-up and help it achieve its short-term and long-term goals.

An ideal option pool for a star-up in India should be between 5% to 10% of the capital. Negotiating the extent of the option pool is crucial for the investors, as well as the founders.

10.4.8 Automatic Conversion Clause

A company may issue debt securities or equity shares, while raising capital. Apart from this, a company may also decide to issue hybrid securities that combine features of both debt and equity. A hybrid security allows investors to purchase a bond that includes an automatic conversion clause. The clause makes the security convertible to equity shares at a pre-determined future period and at a pre-determined valuation. A hybrid security guarantees an investor periodic interest payments on the debt till the conversion date, and dividends on the equity shares post-conversion.

Automatic Conversion right mentions that convertible debt securities or convertible preference shares must compulsorily be converted to equity shares, on the occurrence of a pre-defined trigger or event. The trigger may be a start-up generating minimum INR 10 crore revenue, or raising Pre-Series A Capital, or even a growth company going public through an IPO. As opposed to this, the company may also issue similar hybrid securities with an optional conversion right, wherein the investors have the right but not an obligation to convert their convertible debt securities or convertible preference shares into equity shares of the company. The most important factor here is the conversion ratio decided mutually between the company and the investor. A higher conversion ratio will benefit the investors, as more number of equity shares will be allotted to investors on the conversion.

10.4.9 Protective provisions

Protective provisions in a term sheet provide rights to a class of preferred stockholders (generally minority shareholders or preference shareholders on the Capitalization Table of a company) to approve important decisions made by, or with respect to the investee company. These group of stockholders get the ability to approve or change a corporate action, impacting the shareholders. Some of the events that require approval of preferred stockholders with protective provisions are:

- Changes in the number of preferred shares in any class
- Modification to Memorandum or Articles of Association of the company
- Creating any other class of preferred shares with dividend, liquidation, or voting preferences
- Corporate Restructuring and acquisitions
- Dividend declaration to common or preferred shareholders
- Changing the size of the board of the company
- Redemptions of any shares of preferred stock or common stock
- Dissolution of the company
- Establishing a new option plan or authorizing new shares as part of an option plan

10.4.10 Board composition

When a company is incorporated, it is legally required to set up a board of directors. The board can initially be as small as two directors, with usually the start-up founder on the board. As the start-up grows and evolves over the course of several funding rounds, the board will expand to include more members. Those can include external investors, independent directors, and board observers. To form the Board of the company, the Founder should identify the skill gaps that are lacking but needed at the company, and source directors with experience in these arenas.

There are many benefits to forming a board of directors early in a start-up's lifecycle. A strong board can help the start-up avoid many potential risks early on. But building the right board of directors is also a big challenge, because all the investors in the company may want to have a board representation in the company. The Board of directors is the most important part of a start-up's management structure. However, some start-ups may even decide not to have a conventional board until they have external investors, or have reached a certain scale, such as raising Series A funds. Instead, they might have an advisory board, which can provide advice on investment to the company's leadership without controlling the founders in the way that a board would.

The number of board seats for an investor should be allotted on a pro-rata basis, based on the amount of investment made by such investor. Investors should note that an agreement between the company and investor for a board seat does not in itself, accomplish the steps

of creating the board seat, appointing the investor to the board seat, and binding the other investors to vote in favour of appointing such investor to the board. While negotiating the term sheet clauses the investors should clearly have an understanding on whether they will get a board seat or no. The negotiations also depend on the class of investors and type of investment made in the company.

Compulsory convertible preference shares (CCPS) may not always have a right to a board seat when issued to the preference shareholders. Similarly, every class of equity investors may also not get a board seat in the company's board. The Management Team may not be in favour of every new investor getting a board seat. This involves getting approvals from other existing investors and the risk of increased interference in the business. Hence, a new investor or a Fund Manager should understand the intricacies of getting appointed on the board of a company, which depends on external factors. In case of a Category I AIF or Category II AIF, the investment manager must clearly lay down their investment philosophy, which permits or restricts the fund to invest in a start-up without getting a board seat. Typically, Category II AIFs are in a better bargaining position than individual angel investors to have a board seat, due to their higher ticket size of investment, professional expertise, industry connects and reputation. Lead Investors investing through syndicates also receive one board seat, to represent the interest of the individual investors. Off late, it is seen that Fund investors would reserve a right to appoint a Director or occupy a board seat but would not actually exercise the same in case they feel the litigation risk is very high on them due to issues the investee company might face with stakeholders, regulators etc.

10.5 Regulation on Governance Structure in AIF

The SEBI (AIF) Regulations states that “the sponsor and manager of the AIF shall act in a fiduciary capacity towards its investors and shall disclose to the investors, all conflicts of interests as and when they arise or seem likely to arise. The manager shall establish and implement written policies and procedures to identify, monitor and appropriately mitigate conflicts of interest throughout the scope of business. Managers and sponsors of AIF shall abide by high level principles on avoidance of conflicts of interest with associated persons, as may be specified by the Board (SEBI) from time to time”.

The above provisions make it mandatory for AIF governance structures to be robust and ensure that the sponsor, manager, trustee and other associated parties including service providers act with the highest level of transparency, integrity and trust for the interests of the unit holders (investors). There shall be written policies and organisational structure in place to ensure its compliance.

10.5.1 Role of Fund Governance

Fund governance has become an important topic due to the gigantic size of the fund management industry with particular relevance to the AIF sector. AIFs take unsystematic risk with investors' funds due to which if funds are not governed well and fund managers do not adopt fiduciary responsibilities, the risks for investors become undefined. Simultaneously, institutional investors and family offices /HNIs have become the primary source of investment for AIFs taking highly concentrated risks. Therefore, funds need to demonstrate the presence of governance structures in fund administration.

At its simplest, fund governance means the control structure within which funds are managed, directed and controlled. Manager oversight, outsourced independent valuation, segregation of functions, absence of conflicts of interest plus increased transparency and reporting are the central themes in fund governance. While fund managers play a key role there is a realisation that the fund governance framework also includes the roles played by key service providers such as custodians, prime brokers, administrators, investment advisors and distributors. Indeed, investors may rightly consider the regulator in the jurisdiction where the fund is domiciled to be part of the overall governance framework. While the control structure, including written policies and procedures, is important, good governance also requires a culture within the fund, the manager and other service providers such that investors' interests are of primary importance. Oversight board with sufficient independence, commitment and knowledge to understand the activities of the manager and other service providers can certainly ensure an appropriate control structure is in place and can help create a culture which improves the likelihood of investors' interests being prioritised.

It would be pertinent to note that fund governance also includes high quality engagement with the investee companies by the AIF manager. SEBI has mandated the exercise of 'stewardship responsibilities' by all AIFs (among other institutional investors) with regard to their investments in listed companies.⁸¹ AIFs are expected to shoulder greater responsibility towards their clients / beneficiaries by enhancing monitoring and engagement with their investee companies. Stewardship is intended to protect their clients' wealth and promote fund governance. Stewardship responsibilities include monitoring and actively engaging with investee companies on various matters including performance (operational, financial, etc.), strategy, corporate governance (including board structure, remuneration, etc.), material environmental, social, and governance (ESG) opportunities or risks, capital

⁸¹ Vide SEBI Circular No. CIR/CFD/CMD 1/168/19 dated December 24, 2019 and CFD/CMD1/CIR/P/2020/55 dated March 30, 2020.

structure, etc. Such engagement may be through detailed discussions with management, interaction with investee company boards, voting in board or shareholders meetings, etc. The principles laid down by SEBI for exercising stewardship responsibilities are discussed in Chapter 15.

Most investors in AIFs request specific terms relating to their investment and these are usually documented by way of side letter, although there are restrictions within SEBI regulations on what can be given as an additional right in the side letter. The Sponsor and Investment Manager should ensure that the use of **Most Favoured Nation (“MFN”) provision** in side-letters is regularised, such that certain investors should not be afforded special or additional rights arbitrarily. An MFN provision entitles an investor to elect the benefit of rights contained in other investors’ side letters and potentially also the right to view the other investors’ side letters.

10.5.2 Fund Governance Structure

In a trust-based fund structure, the governance is centred on the AIF trust, the Investment Management Company (Investment manager, AMC) and the Trustee.

The AMC is concerned with all activities of a fund including its investment and divestment related decisions. Specifically, the manager has obligations under the AIF Regulations which are spelt out as follows:

- (a) address all investor complaints;
- (b) provide to SEBI any information sought by the regulator;
- (c) maintain all records as may be specified by SEBI;
- (d) take all steps to address conflict of interest as specified in these regulations;
- (e) ensure transparency and disclosure as specified in the regulations.

SEBI has prescribed a detailed Compliance Test Report (CTR) to be filed by the investment manager at the end of every financial year to furnish the details of compliance with AIF Regulations and circulars issued thereunder.⁸²

The Board of Directors of the AMC are entrusted with the overall supervision and oversight of the investment management functions of the AIF trust while the Trustee is responsible for the overall administration of trust matters. The investment functions, responsibilities and

⁸²Vide Circular No. CIR/IMD/DF/14/2014 dated June 19, 2014. The format prescribed by SEBI is provided in the Annexure to this Circular. For ready reference, it is also furnished at the end of this Unit.

fiduciary obligations of the investment manager and the trustee are spelt out in the trust deed and the investment management agreement respectively in addition to provisions of law (specifically the AIF Regulations) that govern such positions.

10.5.3 Investment Committee (IC) Approvals

The Manager is responsible for investment decisions of the AIF. However, the fund management organisation (AMC or a fund management office run by managers) may constitute an 'Investment Committee' (called by any name) to approve all the investment decisions of the AIF, subject to the following:⁸³

- (i) The Investment Manager of an AIF may constitute an Investment Committee to approve the decisions of the Fund.
- (ii) The members of the Investment Committee shall be responsible for the decisions taken and ensure that they comply with the SEBI (AIF) Regulations. However, members of an Investment Committee set-up by a "large value fund for accredited investors" i.e. AIFs in which each investor, other than Manager, Sponsor, employees/directors of AIF/ Investment Manager, has committed to invest minimum INR 70 crore or equivalent amount in other currency, shall be exempt and not held responsible, provided the members have furnished a waiver to the large value fund for accredited investors, in respect of compliance with the said regulation.⁸⁴
- (iii) The members of the Investment Committee shall abide by the Code of Conduct applicable to the Fund.
- (iv) External members of the Investment Committee, whose names are not disclosed in the PPM or in the agreement made with the investor or any other fund document at the time of on-boarding investors, shall be appointed only with the consent of at least 75 percent of the investors by their value of investment in the AIF. However, consent may not be required for change in ex-officio external members in the Investment Committee set-up by the Investment Manager, such as the Sponsor, Sponsor Group, Investment Manager Group or investors in their official capacity.⁸⁵

⁸³ Inserted by SEBI (AIF) (Second Amendment) Regulations, 2021, w.e.f. May 5, 2021.

⁸⁴ The format for such waiver is provided in the following link: https://www.sebi.gov.in/sebi_data/commondocs/jun-2021/Annexure%201-Waiver_p.pdf

⁸⁵ As per SEBI Circular No.: SEBI/HO/IMD-I/DF6/P/CIR/2021/584 dated June 25, 2021 on Amendment to SEBI (AIF) Regulations, 2012.

Investment proposals are prepared by the investment team of the fund management office and put up to the committee/ manager for in-principle and final screening and recommendations. Each proposal usually contains the following information about the investee company.

- *Executive Summary:* Details of the proposed transaction, background, and overall deal, team recommendation and investment thesis.
- *Company Overview:* History, description, products & applications, customers, suppliers, competitors, organizational structure, management team biographies, etc.
- *Market and Industry Overview:* Key market growth rates, trends, etc.
- *Financial Overview:* Historical and projected income statement, balance sheet, and cash flow statement analysis.
- *Risks and Key Areas of Due Diligence:* Potential risks to the industry/business and key areas of completed and ongoing due diligence.
- *Valuation Overview:* Comparable company analysis, precedent and peer transactions analysis, DCF analysis, multiple based valuation analysis, etc.
- *Exit:* Exit strategy planned, exit options and anticipated timing of exit.
- *Deal Structure and Term Sheet Conditions*
- *Recommendations and Proposed Investment Size and Structure.*

The Manager/ Investment Committee examines every proposal with regard to (a) whether it conforms to the primary investment theme of the scheme, (b) performance, risk profile and management of the investment portfolio and (c) fund level risk concentration and compatibility to the return potential. The Manager/ Investment Committee has to consider the proposal with suitable recommendations to the Board for approval. The investment committee consists of both internal members and external independent members and experts who are not entrusted with the day-to-day management of the AMC to prevent conflict of interest.

It may be noted that in order to process the application for AIF registration and launch of schemes by SEBI, external members of the proposed Investment Committee (to be constituted for investment decisions) of such AIFs, must be resident Indian citizens. However, the applications for AIF registration and launch of schemes wherein the external members of the proposed Investment Committee (to be constituted for investment decisions) are non-resident Indian citizens, shall be processed only after receiving due clarifications from the Government and RBI.⁸⁶

⁸⁶ Vide SEBI Circular No.: SEBI/HO/IMD/DF6/CIR/P/2020/209 dated October 22, 2020 on Processing of applications for registrations of AIFs and launch of schemes.

10.5.4 Investor Advisory Committee

Though, not a mandatory feature in Indian AIF structure, an Investor Advisory Committee consisting of majority Investor representatives may be constituted as a check and balance in the fund system. The Advisory Board's role is to provide informed guidance to the investment manager / IC of the fund based on its own assessment of the affairs of the fund from time to time. The Advisory Board may typically provide its recommendations to the investment manager / IC in relation to areas pertaining to conflict resolution, risk management, governance matters, investor-manager relations and reporting, statutory or tax issues of the fund that may need investor consideration and any other matters that it may find necessary for investor consideration. In some instances, any issues arising out of fund documents that may be of an administrative nature can also be looked into by the Advisory Board.

10.5.5 Role of Board of Directors of AMC

The Board of Directors (BoD) or Designated partner of the investment manager (AMC) play an extremely important role in implementing fund governance from the point of view of realizing the investment potential and serving the best interests of investors. Broadly the important areas of their fiduciary responsibility are listed below:

- BOD must ensure that the PPM, the periodic reporting under the AIF Regulations and other communications issued under its authority complies with applicable laws, that all conflict of interest areas and situations are addressed in the functioning of the AMC.
- BOD to put in place systems to ensure that the investment managers and the AMC team is not just compliant with law and regulation but also acts as per its fiduciary responsibility. No member of the BOD or the investment management team shall be in a position of conflict of interest.
- The terms to be approved for all service providers to the fund and the AMC under the investment management agreement are reasonable and consistent with industry norms and that the overall structure of the fund will ensure a proper division of responsibility among service providers. In particular, service providers have to be carefully chosen based on competence, appropriateness to fund requirements and based on a competitive search. It must be ensured that none of the service providers are in any position of conflict of interest in the performance of their duties.
- The directors should review reports and information they receive from the investment management team and auditors from time to time to independently assess the functioning of the fund and whether it is in line with the fund's investment strategy and compliant with the applicable laws.

- All investment proposals should be deliberated among the directors as required under the articles of association or board protocols and all aspects need to be considered. In particular, the proposal shall conform to the overall investment objectives and theme of the scheme / fund.
- The terms of appointment and remuneration package of executive, non-executive and independent directors should be commensurate to the role and functions expected to be discharged by them.
- The BOD shall evolve a policy and protocols to avoid related party transactions. In the event any specific transaction needs to be approved, the procedure laid out in the Companies Act, the articles of association and the Board policy need to be adhered to. Care must be taken to evolve the policy to outline mechanisms to identify and resolve potential conflicts. Suitable disclosures and measures that demonstrate governance and that the interest of the investors would be unimpaired, should be adopted.
- It cannot be over-emphasised that the BOD has to monitor fund performance, portfolio composition, investment strategies, efficiency and individual contribution of the investment management team, HR policy, audit, reporting and disclosure practices, statutory compliance and investor engagement by the managers. These functions require discharge on an on-going basis not only at board meetings.

10.5.6 Conflict of Interest Issues

One of the key aspects of an AIF administration is to put in place a Code of Conduct for the investment management team and to ensure that all connected parties including external service providers do not have any conflict of interest in the deliverance of their duties. In addition, they should not have any pecuniary interest or other conflicting relationships with the investee companies in which the AIF is invested. Fund performance reporting has to be compliant with law and established methods of valuation and should not be compromised. The interaction with external agencies such as investment bankers for deal sourcing, legal firms for legal and tax advice, accounting firms for due diligence, valuation and reporting, auditors for certification of the books of the AIF trust etc. are critical areas for high level of transparency, governance and ethics. These aspects are fundamental to achieving the desired standards of delivery of the fiduciary responsibility to investors in the AIF. Hence, in order to resolve potential conflicts of interest, the Sponsor or Investment Manager must:

- Disclose all potential conflicts of interests to the investors, as and when they arise or seem likely to arise.
- Establish and implement written policies and procedures to identify, monitor and appropriately mitigate conflicts of interest.

- Enforce high level principles on avoidance of conflicts of interest with associated persons.

The SEBI Circular on Stewardship Responsibilities (referred to in Chapter 12) lists out the following actions for addressing conflict of interest.

- Identifying possible situations where conflict of interest may arise. E.g. in case of investee companies being associates of the entity.
 - Procedures put in place by the entity in case such conflict of interest situations arise which may, *inter alia*, include:
 - (i) Blanket bans on investments in certain cases
 - (ii) Having a 'Conflict of Interest' Committee to which such matters may be referred to.
 - (iii) Clear segregation of voting function and client relations/ sales functions.
 - (iv) Policy for persons to recuse from decision making in case of the person having any actual/ potential conflict of interest in the transaction.
 - (v) Maintenance of records of minutes of decisions taken to address such conflicts.
- Periodical review and update of such policy and public disclosure.

10.5.7 Managing the stakeholders in PE deals

All Investment Managers and Sponsors should ensure that the interest of all stakeholders is managed effectively. They should leverage the views of different stakeholders to sharpen their approach to allocating capital to potential investee companies. As part of their decision-making, Investment Managers typically make investments as per the stated investment objective. The manager should balance between directing funds into strategic and longer-term investments, so that they can navigate their way through stakeholders' differing aims and goals.

The stakeholders in a Private Equity deal include institutional investors, High net-worth individuals, foreign investors, sovereign wealth funds, start-ups or investee companies, employees, investment management team, distributors, and other service providers such as fund administrators, legal counsels, auditors, due diligence experts, SEBI, Registrar and Transfer Agents and Custodians, if applicable. Start-ups and investee companies work on innovative ideas and always prefer least interference from their investors and Private Equity Funds. However, the institutional investors, family offices and foreign investors always prefer investing in start-ups who offer them a board seat or preferential rights, such as a Veto Right. If the investment manager and the Private Equity Fund is primarily serving Institutions, they should have internal policies to identify only potential growth-stage and mature companies which can dedicate time and resources towards corporate governance and increased transparency. This may involve a human element of judging the management team, performing background checks on the founder and scrutinizing the intent of fund-

raising, besides seeing the market potential, revenue models and execution plans of the company.

To ensure stakeholder management, some Private Equity Funds have internal policies which report their operations and investment-making decisions. This shows how many investments are made only with the intent of growth, or also with the intent of satisfying stakeholders' requirements, such as ESG investing. Funds can have automated tools that can help categorize investments, providing a common platform for evaluating them and supplying sufficient detail to fuel informed decision-making.

At the time of forming the fund, investment manager or sponsor should ensure that they clearly understand the intent of every stakeholder. For example, a family office would look at an investment through the lens of "opportunity cost" and check where else can they get similar or better returns for similar risk. However, an institutional investor like a Pension Fund may be more inclined toward strategic and long-term investments, and less inclined towards predictable and short-term deployment of capital. Hence, the sponsor or manager should ideally create a forum where stakeholders have room to express relevant views, through committees such as a Stakeholder Management Committee. This Committee should be responsible to set clear and measurable objectives for the fund, design a process to assess investment decisions and most importantly, understand the roles, responsibilities and objective of each stakeholder group.

10.5.8 Investor Grievances and Dispute Resolution

AIF Managers are obliged to address all investor complaints, take all steps to avoid conflict of interest, ensure transparency, provide necessary information and disclosures to SEBI and investors, and maintain relevant records for the same.

To make the process comprehensive and effective, SEBI has notified the SEBI (Facilitation of Grievance Redressal Mechanism) (Amendment) Regulations, 2023. Based on these regulations, AIF Managers shall redress investor grievances within 21 calendar days from the date of receipt of the grievance. For this purpose, SEBI has a web based centralised grievance redress system called **SEBI Complaint Redress System (SCORES)** at <http://scores.gov.in> where investors can lodge their complaints against AIFs. Complaints lodged against the AIF on the SCORES platform will be automatically forwarded to the AIF for resolution and reporting through the Action Taken Report (ATR). The ATR will be automatically routed to the investor who has filed the complaint. For implementing an effective Investor Grievance Redressal Mechanism, SEBI has specified the Framework for handling of investor grievances received through SCORES by Entities and monitoring of the redressal process by designated bodies.⁸⁷ The complaint against the AIF will simultaneously be forwarded to the Designated Body for AIF investor grievance redressal, who ensure that the AIF submits ATRs within the stipulated time of 21 calendar days from the date of receipt of the complaint. The

⁸⁷Annexure 1 of SEBI Circular No. SEBI/HO/OIAE/IGRD/CIR/P/2023/156, dated September 20, 2023

Designated Body for AIFs will monitor the ATRs submitted by the AIF and inform the AIF to improve quality of redressal of grievances, wherever required.

First Review: Investors in the AIF can also request a review of the resolution provided by the AIF, within 15 calendar days of receiving the ATR mentioned above. If the investor remains dissatisfied or if the AIF fails to submit the ATR within the specified timeframe, the Designated Body for AIFs will initiate the first review, seek clarification on the ATR and establish deadlines for revised ATR submission. The designated body will upload ATR on SCORES within 10 days, which will be automatically routed to the investor through SCORES platform.

Second Review: Investors can request a second review within 15 calendar days of receiving the revised ATR from the designated regulatory body. If the investor remains unsatisfied or the ATR submission faces delay by more than 10 calendar days, SEBI may take cognizance of the Complaint for second review through SCORES platform. SEBI may intervene for a second review and take up the review with stakeholders involved, including the AIF or/and Designated Body. In such case, the AIF must promptly submit a revised ATR to SEBI through SCORES platform, within the timeline specified by SEBI. The second review Complaint shall be treated as 'resolved' or 'disposed' or 'closed' only when SEBI 'disposes' or 'closes' the Complaint in SCORES platform.

Investors can approach the **Online Dispute Resolution (ODR)** route or other appropriate civil remedies at any point of time. In case the complainant opts for Online Dispute Resolution mechanism or other appropriate civil remedies while the complaint is pending on SCORES, the complaint shall be treated as disposed on SCORES. All claims, differences or disputes between investors and the AIF or its Manager arising out of or in relation to the activities of the AIF or its Manager shall be submitted to a dispute resolution mechanism that includes mediation and/or conciliation and/or arbitration, in accordance with the procedure specified by SEBI.⁸⁸

AIFs and its investors may refer any unresolved issue of any service requests or service-related complaints by harnessing online conciliation and/or online arbitration. Service-related complaints shall include non-receipt/ delay of account statement, non-receipt/ delay of bills, closure of account/branch, technological issues, shifting/closure of branch without intimation, improper service by staff, freezing of account, alleged debit in trading account, contact person not available, demat account transferred without permission etc.

Market Infrastructure Institutions (MIIs) are in process to set-up an ODR Portal. AIFs must enrol on the portal, and ensure implementation of related processes and requirements, specified by SEBI.⁸⁹ The enrolment process shall also include executing electronic terms/agreements with MIIs and the ODR Institutions, which can be done using the credentials used for SEBI SCORES portal / SEBI Intermediary portal. AIFs should display a link to the ODR Portal on the home page of their websites and mobile apps. The modalities of

⁸⁸SEBI Circular No. SEBI/HO/OIAE/OIAE_IAD-1/P/CIR/2023/131, dated July 31, 2023

⁸⁹SEBI Circular No. SEBI/HO/OIAE/OIAE_IAD-1/P/CIR/2023/131, dated July 31, 2023

the ODR Portal along with the relevant operational guidelines and instructions are specified by SEBI.

AIFs must promptly attend to all complaints or disputes raised by its investors or clients in accordance with applicable SEBI rules, regulations and circulars. The communications shall clearly specify, the availability of the SCOREs portal and the ODR Portal to the investor and that the same could be accessed by such investor, if unsatisfied with the response or the lack thereof of the AIF. The staff of AIFs shall be duly trained to attend to complaints/disputes and in handling the references arising from the SCOREs portal or the ODR Portal, and in participating in online conciliation and arbitration. Due cooperation and coordination with the MIIIs and with the ODR Institutions shall be ensured by the AIFs.

If the AIF has been established as a trust, then no loss or damage or expenses incurred by the Manager or officers of the Manager, including those in relation to resolution of claims or disputes of investors, shall be met out of the trust property.

10.6 Role of Human Capital in avoiding Conflict of Interests

Human capital in a fund includes the investment manager, its team and other support employees that are involved in decision making, both directly and indirectly. Making an unbiased decision that aligns with the interest of the investors of the fund requires good logical and analytical skills of the fund manager and his team. Fund managers and team are required to take adequate steps to identify, manage, monitor and disclose conflicts. Thus, the fund manager shall implement the following measures to avoid conflict of interest:

- Putting in place internal policies and procedures in managing conflict of interests
- Establishing appropriate 'Chinese walls' protecting confidentiality
- Regular training and upskilling of team members on market and regulatory changes
- Applying due skill, care and diligence in selecting the outsourcing companies

Further, the investment manager has a fiduciary duty to safeguard the interest of investors in the fund. The decision-making process and internal policies should be structured in a manner which ensures that interests of investors and manager are always aligned. Alignment of Interests ensure that decisions taken by investment managers benefits all parties, without any conflicts between all stakeholders in the fund management activity. Some examples of alignment of interest for AIF Managers are mentioned below:

- Apart from the minimum sponsor commitment, the sponsor and fund manager should list other fund management activities carried out in a year, to indicate the amount of time dedicated by the sponsor or fund manager to the fund, predecessor funds and establishing successor funds.
- Establish circumstances under which the setting up, marketing and investment period of a new scheme can be undertaken, as well as the rules of coexistence

between the existing scheme and the new scheme, and allocation of Management Fees thereon.

- The Sponsor should not set up a new scheme, particularly one with similar target investments, until the end of the investment period of the ongoing scheme, or until the capital of the relevant scheme has been substantially invested.
- Achieving first close within a reasonable time, once the PPM document has been filed with SEBI and not wait for 12 months to expire, as per SEBI.
- Equal treatment and terms for investors investing in the fund and ensuring that the investment manager fulfills the fiduciary duty of safeguarding investor interest.
- If extension of the fund tenure is not approved, the manager shall proceed to winding up the Fund, providing the investors with information on the conditions in which said winding up will be carried out. If fund tenure is being extended, the investors must be provided with clear information on reasons for such extension and the conditions in which extension will be carried out.
- Information on the management fee received, or to be received, by the manager should be included in the regular updates sent to the investors, specifying the basis for calculation. Similarly, details on performance-based fees must also be given, along with the basis of calculation and clear definitions of triggers which may attract a clawback provision.
- If the manager is retaining sales proceeds from an investment for the purpose of re-investment by the fund, investors should be communicated under what conditions or scenarios will the reinvestment be done, and subject to quantitative and time limitations. The reinvestment cannot exceed the capital invested (or the acquisition price) in the asset that gave rise to the income distribution, which is subject to reinvestment.
- The Investors shall be provided with clear information if any kind of fees is paid directly or indirectly by the Portfolio Companies to the manager, or any of its affiliates.
- Managers should clearly identify the type of organizational and marketing expenses that will be borne by the Fund, and their limits with respect to its total investment commitments. Likewise, the manager must list the operating expenses of the Fund, such as auditing, legal advice, taxes, payment of service providers, etc., as well as the amount of these expenses to be borne by the Fund itself.
- The manager must always refrain from co-investing in deals that may potentially generate conflict of interests with the investors.
- The investors should be provided with annual and quarterly reports, with details of the investments made, financial statements, fund leveraging plan if applicable, material changes in investments, valuation mechanisms used and any change in the valuation mechanisms, etc.
- The existence of a side letter should have objective justification.

10.7 Co-investments in AIFs

Co-investments are an integral part of the AIF investment paradigm when the investors wish to invest along with the fund directly into the investee company. In a co-investment arrangement, the investors in the AIF may partner with it to invest directly into one or more of the investments being made by the AIF.

This structure is beneficial when offshore investors do not wish to pool their funds with the Domestic Fund Manager and prefer to have their own freedom to shortlist investee companies, before investing in them. This is normally useful for large institutional investors who make investment decisions based on their firm's investment policies and risk-return objectives. In principle, co-investments, either as sole investor or as a co-investor with a private equity firm, provides greater control for the investors in the selection of particularly attractive investments while saving on fees.

Although AIF fund managers are professionals in their own right and bring in considerable expertise in fund management, high fees and the poor performance by some fund managers can become an enabler to increased preference for co-investments by investors. Globally as well as in India, blind pools are slowly making way for more hybrid structures, wherein investors are demanding special rights to participate in co-investment opportunities alongside the fund, wherein while the investors take a call whether to invest or not, all other decisions in relation to the investment are taken by the investment manager jointly alongside the fund / blind pool. This is to ensure that the interests of the fund / blind pool are tied-in with the co-investors.

Recently, SEBI specified that co-investment by investors of Category I AIF and Category II AIF shall be only through a co-investment Portfolio Manager as specified under the SEBI (Portfolio Managers) Regulations, 2020. Co-investment means investment made by a Manager or Sponsor or investor of Category I AIFs and Category II AIFs in investee companies where such Category I AIF and Category II AIF make investment.⁹⁰

The terms of Co-investment in an investee company by a Manager or Sponsor or co-investor, shall not be more favourable than the terms of investment for the AIF. Also, the terms of exit from the Co-investment in an investee company, including the timing of exit, shall be identical to the terms applicable to that of exit of the AIF. Further, the manager shall not provide advisory services to any investor other than the clients of Co-investment Portfolio Manager as specified in SEBI (Portfolio Managers) Regulations, 2020, for investment in securities of investee companies where the fund makes investment.

10.8 Code of Conduct of Investment Managers of AIFs and Investment Committee

⁹⁰ Vide SEBI Circular No. SEBI/HO/IMD/IMD-I/DOF6/P/CIR/2021/663 dated November 22, 2021 on Clarifications regarding amendment to SEBI (AIF) Regulations, 2012.

Investment manager and key management personnel of the investment manager of AIFs shall abide by the Code of Conduct specified in the SEBI (Alternative Investment Funds) Regulations.

For this purpose, “key management personnel” shall mean:⁹¹

- members of key investment team of the Manager, as disclosed in the PPM of the fund
- employees involved in decision making on behalf of the AIF, including but not limited to, members of senior management team at the level of Managing Director, Chief Executive Officer, Chief Investment Officer, Whole Time Directors, or such equivalent role or position
- any other person whom the AIF (through the Trustee, Board of Directors or Designated Partners, as the case may be) or Manager may declare as key management personnel.

AIFs should disclose the name of all their key managerial personnel and the investment manager in the private placement memorandum. Any change in the key managerial personnel shall be intimated to the investors and SEBI.

The following Code of Conduct has been prescribed by SEBI for the Managers of AIF and key management personnel of Managers and AIFs:

Every Manager of an AIF and key management personnel of the manager and fund shall:

- a) Abide by the Act, Rules, Regulations, Guidelines and Circulars as applicable to AIF at all times.
- b) Maintain integrity, highest ethical and professional standards in all its dealings.
- c) Ensure proper care and exercise due diligence and independent professional judgement in all its decisions.
- d) Act in a fiduciary capacity towards investors of the AIF and ensure that decisions are taken in the interest of the investors.
- e) Abide by the policies of the AIF to identify, monitor and appropriately mitigate any potential conflict of interest throughout the scope of its business.
- f) Not make any misleading or inaccurate statement, whether oral or written, either about their qualifications or capability to render investment management services or their achievements.
- g) Record in writing, the investment, divestment and other key decisions, together with appropriate justification for such decisions.
- h) Provide appropriate and well considered inputs, which are not misleading, as required by the valuer to carry out appropriate valuation of the portfolio.
- i) Not enter into arrangements for sale or purchase of securities, where there is no effective change in beneficial interest or where the transfer of beneficial interest is only between parties who are acting in concert or collusion, other than for bona fide and legally valid reasons.

⁹¹ Vide SEBI Circular No.: SEBI/HO/IMD-I/DF6/P/CIR/2021/584 dated June 25, 2021 on Amendment to SEBI (AIF) Regulations, 2012.

- j) Abide by confidentiality agreements with the investors and not make improper use of the details of personal investments and/or other information of investors.
- k) Not offer or accept any inducement in connection with the affairs of or business of managing the funds of investors.
- l) Document all relevant correspondence and understanding during a deal with counterparties as per the records of the AIF, if they have committed to the transactions on behalf of Fund.
- m) Maintain ethical standards of conduct and deal fairly and honestly with investee companies at all times.
- n) Maintain confidentiality of information received from investee companies and companies seeking investments from the AIF, unless explicit confirmation is received that such information is not subject to any non-disclosure agreement.

In addition to the above, SEBI has also outlined the Code of Conduct for members of the Investment Committee, trustee, trustee company and its director, directors/ designated partners of AIF. This includes:

- i. maintaining integrity and the highest ethical and professional standards of conduct; ensuring proper care and exercising due diligence and independent professional judgment in carrying out their roles;
- ii. disclosing details of any conflict of interest relating to any decisions in a timely manner to the Manager of the AIF, adhering with the policies and procedures of the AIF with respect to any conflict of interest and wherever necessary, recusing themselves from the decision-making process;
- iii. maintaining confidentiality of information received regarding the AIF, its investors and investee companies; unless explicit confirmation is received that such information is not subject to any non-disclosure agreement;
- iv. not indulging in any unethical practice or professional misconduct or any act, whether by omission or commission, which tantamount to gross negligence or fraud.

10.9 Industry Best Practices

Governance:

- The manager can set up a Supervisory Committee which meets at least once a year and list the composition and powers of the Committee. Powers generally comprise the valuation of assets that exceed the pre-defined maximum investment per Company, governance issues and terms and conditions of the Fund, and the resolution of potential conflicts of interest. The Supervisory Committee resolutions cannot, in any way, replace the mandatory consent of the Investors for certain

matters. The Manager should promptly inform the Supervisory Committee of any transactions during the investment period that may give rise to potential conflicts of interest.

- Identify the Key Persons or Key Executives of the fund and take a Keyman Insurance as well as Indemnity Insurance. The Key Persons or Key Executives should inform the Investors of any situation that can substantially affect their dedication to the Fund.
- The investment strategy must be clearly determined the relevant jurisdictions, the type of Investee Companies in which the Fund invests, the maximum amount of each investment, concentration restrictions, as well as a list of excluded sectors in which the Fund will not invest.

Deal Structuring and Investment Strategy:

- The manager should assess the potentially available investment instruments and determine which is appropriate for each deal, on a case-by-case basis. There should not be only one investment instrument which is used for investment.
- The manager should have a preliminary assessment of the full value chain of each potential investment, identifying risks and opportunities including assessment of ESG risks and opportunities. The manager should design high-powered incentives for the management team, key employees and/or other key people of the Target aligned with the goals of the deal, granting the beneficiaries part of the returns resulting from an exit.

Cyber Security and Cyber Resilience framework (CSCRF) for AIFs:⁹²

With rapid technological advancement in the securities market, there is a greater need for maintaining robust cyber security and to have a cyber resilience framework to protect the integrity of data and guard against breaches of privacy.

As part of the operational risk management, the AIFs need to have robust cyber security and cyber resilience framework in order to provide essential facilities and services and perform critical functions in the securities market as Investment Manager.

Accordingly, all AIFs with asset under management (AUM) as specified by SEBI should follow the Cyber security guidelines as published by SEBI. The applicability of various standards and guidelines of CSCRF is based on different categories of SEBI Regulated Entities (REs).

CSCRF follows a graded approach and classifies REs in the following five broad categories:

- a) Market Infrastructure Institutions (MIIs)
- b) Qualified REs
- c) Mid-size REs

⁹²SEBI Circular No.: SEBI/HO/ITD-1/ITD_CSC_EXT/P/CIR/2024/113 dated August 20, 2024.

- d) Small-size REs
- e) Self-certification REs

The category of REs shall be decided at the beginning of the financial year based on the data of the previous financial year. Once the category of RE is decided, RE shall remain in the same category throughout the financial year, irrespective of any changes in the parameters during the financial year. The respective reporting authority shall validate the category at the time of compliance submission. Further, the criteria given and their thresholds for different categories will continue to be updated as and when required. Criteria and thresholds for AIFs category as follows:

Criteria	Self-Certification REs	Small-size REs	Mid-Size REs	Qualified REs
AUM	Less than Rs. 100 Crores	Rs.100 crores and above but less than Rs.500 crores	Rs. 500 crores and above but less than Rs. 1000 crores	Rs. 1000 crore and above

Sample Questions: Chapter 10

1. The due diligence review is conducted by _____.

- a. the trustee of the AIF
- b. the auditor of the AIF
- c. an agency appointed by the investment manager**
- d. an investment bank appointed by the manager

2. The term sheet is entered into by _____.

- a. the manager with a potential investee company**
- b. the sponsor with the investor
- c. the fund with the manager
- d. the distributor with the investor

3. The following is a 'definitive agreement' for an AIF investment.

- a. Private Placement Memorandum
- b. Subscription agreement**
- c. Articles of Association
- d. Trust deed

4. A 'ratchet' protects the AIF from a future down round. State whether True or False.

- a. True**
- b. False

CHAPTER 11: VALUATION

LEARNING OBJECTIVES:

After studying this chapter, you should know about:

- Basics of valuation of fixed income instruments
- Various approaches to equity valuation
- Various approaches to business valuation
- Different techniques of valuation (Asset based valuation, Discounted cash flow valuation and Relative valuation)
- Valuation of AIF portfolio investments (Valuation Guidelines by IPEV)
- General approaches to fund valuation and regulations thereof
- Role of Valuers and limitations of valuation

11.1 Introduction

Valuation of assets and businesses is an essential element of financial investments in businesses, financial markets and more specifically, in alternative investments. Though there are several approaches, the most acceptable by theoretical standards is the one that estimates the value of an asset as the present value of its future cash flows. In theory therefore, the value of any financial investment is the Net Present Value (NPV) of its future cash flows i.e., $\Sigma = NPV$. This method is also known as the 'Discounted Cash Flow' or the DCF method of valuation. Under this method, the value of an asset is represented as:

$$\text{Value of Asset} = \frac{\text{Sum of Future Cash Flows}}{(1 + r)^n}$$

wherein: r represents the applicable discounting rate; n represents the number of periods over which the discounting rate is applied

Though the DCF appears to be a straight forward calculation, it is fraught with difficulty. The calculation is also extremely sensitive to the timing of any cash flow. The difference between receiving a cash flow at the start or the end of the year has material impact on NPV. There are other methods such as asset based valuation, relative valuation and market based valuation but these approaches are used more to corroborate the fundamental value derived from cash flow based valuation.

11.2 Valuation Basics for Fixed Income Instruments

Fixed income instruments or debt securities provide predictable returns. Fixed income valuation is applicable in an AIF context for three reasons:

- a) AIFs that are floated as debt funds could invest in debt securities of investee companies and other entities such as SPVs, InvITS and REITs.
- b) AIFs use debt structures in financing investee companies either as a complementary structure to equity financing or as convertibles that would become equity after set milestones are reached.
- c) AIFs may also invest in debt securities in the listed or unlisted space to manage risk profile and liquidity of the scheme / fund.

The value of a fixed income bearing instrument such as a bond or a debenture with periodic interest payments can be represented as:

$$\text{Value} = I (\text{PVA}_{(r,n)}) + F (\text{PV}_{(r,n)})$$

Where 'I' is the annual interest payable on the bond, 'F' is the principal amount (par value) of the bond, 'r' is the required return on the bond, and 'n' is the maturity period.

Illustration 11.1

A INR 100 par value bond, bearing an annual coupon rate of 12 percent will mature after 8 years. The required rate of return on this bond is 14 percent. What is the value of this bond?

Since the annual interest payment will be INR 12 for 8 years, and the principal repayment will be INR 100 at the end of 8 years, the value of the bond will be:⁹³

$$V = \text{INR } 12 (\text{PVA}_{14\%, 8 \text{ yrs}}) + \text{INR } 100 (\text{PV}_{14\%, 8 \text{ yrs}})$$

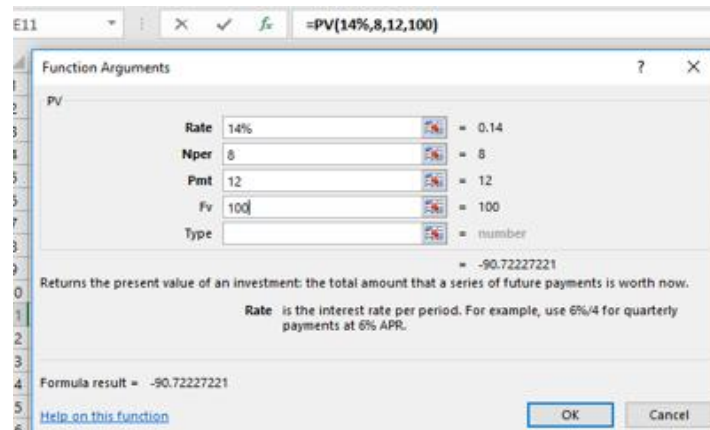
⁹³PVA is the Present Value Annuity Factor. It is calculated as the annuity factor for 'n' time periods at a rate of return 'r' as $\text{PVA}(n,r) = (1 - (1 + r)^{-n}) / r$. In the given case it would be $= (1 - (1 + 0.14)^{-8}) / (.14) = 4.639$.

On similar lines, when any future number is multiplied by the PV factor, we arrive at its present value. The PV factor is calculated as $1/(1+r)^n$ where n is the number of time periods and 'r' is the rate of return. In the given case, the PV factor $= 1/(1 + 0.14)^8 = 0.351$.

Both these factors can be calculated using the formulae stated above on a calculator or a spreadsheet. For ready reference, these factors can also be looked up on annuity factor tables and discounting factor tables that are found on the internet in a google search. Printed table books are also available either as separate publications or as appendices at the end of finance text books.

$$= \text{INR } 12 (4.639) + \text{INR } 100 (0.351) = \text{INR } 90.77$$

This can be solved in a spreadsheet using the PV function as follows: =PV(14%,8,12,100)



Where, rate = the required rate of return; Nper = tenure of the bond; Pmt = coupon payments; Fv = future value of the bond.

Illustration 11.2

A INR 1,000 par value bond, bearing an annual coupon rate of 14 percent, will mature after 5 years. The required rate of return on this bond is 13 percent. What is the value of this bond?

Since the annual interest payment will be INR 140 for 5 years and the principal repayment will be INR 1,000 at the end of 5 years, the present value of the bond will be:

$$\begin{aligned} V &= \text{INR } 140 (\text{PVA } 13\%, 5 \text{ yrs}) + \text{INR } 1,000 (\text{PV}_{13\%, 5 \text{ yrs}}) \\ &= \text{INR } 140 (3.517) + \text{INR } 1,000 (0.543) \\ &= \text{INR } 1,035.4 \end{aligned}$$

It can also be solved in a spreadsheet as: =PV(13%,5,140,1000)

11.3 Approaches to Equity Valuation

Similar approach as above can be used to estimate the value of an equity share in a company from an investor perspective using the present value of its expected dividend cash flow in future. However, this approach has limited relevance for alternative investments which are primarily made in unlisted companies that have high growth potential. So, the emphasis here is not on distribution of profits but to generate high valuation with internal growth. Many of such investee companies may also lack sufficient distributable surplus. Therefore, there is a

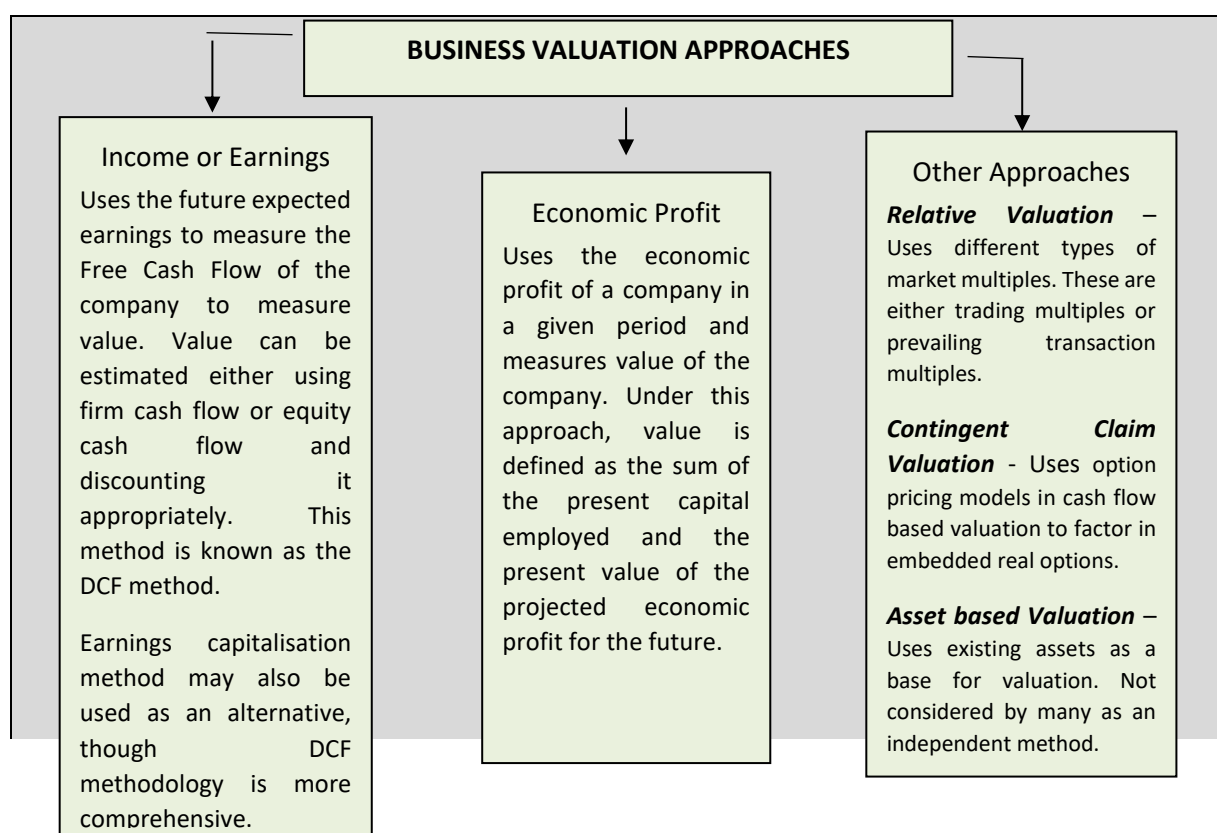
need to look at valuation of the business of the investee company to arrive at the valuation of its share.

11.4 Approaches to Business Valuation

Though several approaches to valuation are available as shown above, the ones that are mainly used are (i) the earnings approach based on DCF analysis (income approach), (ii) the relative valuation based on earnings multiples (market approach) and (iii) the asset based approach (cost approach). The income or earnings based approach often scores over the other methods such as asset based methods (cost approach) and relative valuation based on market multiples. This is because the cost approach does not consider some critical drivers of value as the income approach. However, the income approach has several judgemental factors and assumptions to be made which make it quite subjective. The use of relative valuation is tricky since it requires comparing 'an apple to an apple'. Therefore, the valuation could be misleading if comparable data is not available for a particular business. As such, when business models are unique or comparable data is not available, the relative valuation approach may not be appropriate.

The following chart summarises the various approaches to business valuation.

Business Valuation Overview⁹⁴



⁹⁴Extracted from Investment Banking – Concepts, Analyses and Cases – Pratap Giri S. McGraw Hill 2017 Page 239

11.4.1 Enterprise Value (EV) and Equity Value

At this stage, before we attempt to understand the various methodologies available to value a business / company, it is necessary to appreciate the difference between Enterprise Value and Equity Value.

Enterprise value (EV) is the debt-free/cash free value of the operating business. EV is measured with reference to the earning potential (gross operating cash flow) which in profit terms refers to the earnings before interest, tax, depreciation and amortisation (EBITDA) and reflects the estimate of the value of the business regardless of how it is financed. Therefore, EV is the value of the total capital in the company or business regardless of whether it is debt or equity capital. Equity value or market capitalisation (market value of a listed company) is the value of 100% of the shares of the company (total equity capital). It measures the total value of funds belonging to equity shareholders in the company after all other, including debt and preference capital, have been deducted.

The relationship between EV and Equity Value is shown below.

$$\text{Enterprise Value (EV)} = \text{Equity Value (Market Cap)} + \text{Total Debt (net of cash)} + \text{Preference capital (if any)}$$

Illustration 11.3

Company's estimated Market Cap = INR 1000 crore

Long Term Debt on the balance sheet = INR 200 crore

Outstanding Preference Capital = INR 50 crore

Cash on the balance sheet = INR 5 crore

Enterprise Value = $1000 + (200 - 5) + 50 = \text{INR } 1245 \text{ crore}$

11.5 Asset based Valuation

Under this method, the value of the equity share of a company is arrived at as the 'net asset value' per share, i.e. the total net asset value of the company is divided by the number of outstanding shares in the company to arrive at the value per share. This method does not take into account any future value attributable to the business and considers only the market

value of the assets less liabilities of the company. Asset based valuation can be done from three approaches – (1) Book Value or Net Asset Value (NAV) approach, (2) Replacement Cost approach and (3) Break-up Value approach.

Under the first method, all the assets and liabilities of the company as on the valuation date are considered at historical carrying cost in the books. If the assets and liabilities are considered only at their balance sheet values (known as 'historical cost'), then we will arrive at the 'book value' per share of the company. Book value of share of a company is normally considered the 'floor price' or the least value attributable to a 'going concern' business which is expected to continue in business in future.

Under the second method, the value of the business is estimated at the cost of replacement of the entire business on as-is-where-is basis. Essentially, the market cost of the assets and liabilities with suitable adjustments for their current position are considered. In addition to the cost of acquisition of the assets, the costs related to establishment of the business as a going-concern in its present state are considered. This method is appropriate for businesses that have high entry barriers or setting up costs

The third method considers the salvage value of a business if it were shut down on the valuation date. Therefore, this method is also known as the 'break-up value' method since it measures the current market value of the company if it is broken up and sold in individual pieces of assets. Break-up value method is used to value a company that is in distress or does not have a future business case.

Book value per share measurement based on Net Asset Value is measured as follows:

$$\text{Book Value per Share} = \frac{\text{Equity Shareholders' funds as per balance sheet}}{\text{No. of equity shares issued and paid up}}$$

The break-up value of share of a company is measured as follows:

$$\text{Break up Value per Share} = \frac{\text{Liquidation Value of Assets} - \text{Settlement Value of Debt}}{\text{No. of equity shares issued and paid up}}$$

Illustration 11.4

Alpha Ltd. provides its summary balance sheet data as on the valuation date as shown below.

Balance Sheet of Alpha Ltd				Rs.crore
Equity Share Capital	100,000	Fixed Assets		12,000,000
General Reserve	5,000,000	Investments		1,000,000
Revaluation Reserve	1,500,000	<u>Current Assets</u>		
Capital Redemption Reserve	2,500,000	Inventory		3,500,000
Debenture Redemption Reserve	2,000,000	Receivables		2,500,000
P&L Surplus	500,000	Intangible Assets		1,000,000
Long Term Debentures	4,000,000			
Bank borrowings	3,000,000			
Trade Payables	1,000,000			
Other Current Liabilities	400,000			
Total	20,000,000			20,000,000

Total number of outstanding shares is 10,000.

Further information is provided as follows.

1. The current market value of fixed assets would be 10% lower on a going concern basis. However, if they are scrapped, they would fetch 40% of their book value.
2. Inventory would cost 10% higher in the market and receivables would fetch 25% lower than book value on liquidation. Market value of payables would be 15% lower on liquidation.
3. It would cost an additional INR 20,00,000 as setting up costs for initial licences, registrations and approvals as well as pre-operative costs.
4. Intangible assets consist of trademarks and patents which would fetch INR 5 lakh more if they were sold.

I. Computation of Book Value

	INR	INR
Equity Capital	1,00,000	
<u>Cash reserves</u>		
General reserve	50,00,000	
CRR	25,00,000	
DRR	20,00,000	
Surplus in P&L account	5,00,000	
Total Cash net worth⁹⁵	1,00,00,000	

⁹⁵ Cash network does not include revaluation reserve. Hence it is excluded from valuation.

Tangible net worth (Equity Value of the Business)		101,00,000
No. of shares (nos.)		10,000
NAV per share (Rs)		1,010

II. Computation of Break-up Value

	INR	INR
Tangible net worth as shown in table above	101,00,000	
Add appreciation in stock and intangible assets and reduction in payables (3.5L+5L+1.5L)	10,00,000	
Less depreciation in scrap value of fixed assets and receivables (72L+6.25L)	78,25,000	
Break-up value of business (Equity Value)		32,75,000
No. of shares (nos.)		10,000
Break-up value per share (Rs)		327.50

III. Computation of Replacement Value

	INR	INR
Book Value of Assets	200,00,000	
Add appreciation in stock, intangibles (3.5L+5L)	850,000	
Add additional setting up costs	20,00,000	
Less depreciation in fixed asset value on going concern basis	12,00,000	
Replacement Value of business (Enterprise Value)		2,16,50,000

Asset based valuation is not considered an independent method and when it is employed, it would more often than not be used in conjunction with other methods assigning appropriate weightage based on its overall importance in the given valuation context. As mentioned above, it is most appropriate for asset heavy businesses and distressed companies facing liquidation. It is also ideal for financial businesses such as banks and financial or investment companies.

11.6 Discounted Cash Flow (DCF) Valuation

The DCF methodology is based on finding the present value of the free cash flow of a company by discounting such cash flow at its weighted average cost of capital (WACC). The free cash flow is usually computed for a specified forecasting period of about 5 years and thereafter a perpetual terminal value is added to it. The sum of the present value of the forecasted free cash flow and the terminal value provides the present value of the company's business. From this consolidated value, the outstanding debt in the company is deducted to arrive at the equity value of the company. This equity value when divided by the number of outstanding equity shares provides the value per share in the company. The above explained process is in brief, the DCF method of valuation of a share of a company. These steps are illustrated below through an example.

Illustration 11.5: Worked Out Example

In order to do the valuation of a company under the DCF method, it is required to estimate the future operating cash flow (OCF) by working out a detailed projected P&L account. This would depend on several estimates of revenues and costs to be made keeping business variables under consideration. Similarly, necessary workings have to be made for interest on borrowed capital, depreciation on fixed assets and tax liability computations. Based on the future projections, the OCF is worked out as follows –

$$\text{OCF} = \text{PAT} + \text{Depreciation} +/- \text{Non-cash charges in the P\&L Account} +/- \text{Changes in working capital}$$

If there are re-investment requirements in fixed assets, these are netted out from OCF to arrive at Free Cash Flow from Operations.

For the purpose of our study, let us consider that a company has provided us with the following estimates of its Profit after Tax (PAT), Depreciation and other details for a forecasted period of next 5 years as follows.

Demonstration Investee Company Limited						
Year ending March (in Rs. Lakh)	Y0	Y1	Y2	Y3	Y4	Y5
Free Cash Flow Computation						
Profit After Tax	1,078.00	1,369.29	1,599.40	1,857.51	2,173.29	2,542.74
Depreciation	8.40	10.23	11.25	12.38	13.87	15.53
Other Amortisations	10% 107.80	136.93	159.94	185.75	217.33	254.27
Gross Free Cash Flow	1,194.20	1,516.45	1,770.58	2,055.64	2,404.48	2,812.55
Changes in working capital	10% -	136.93	159.94	185.75	217.33	254.27
Capital commitments	-	2.19	2.41	2.65	2.92	3.21
Free Operating Cash Flow	1,194.20	1,377.33	1,608.24	1,867.24	2,184.24	2,555.06
Non-Operating Income	2%	27.55	32.16	37.34	43.68	51.10
Total Free Cash Flow	1,194.20	1,404.87	1,640.40	1,904.58	2,227.92	2,606.17

Step1 – Free Cash Flow during the Forecasted Period

Demonstration Investee Company Limited						
Year ending March (in Rs. Lakh)	Y0	Y1	Y2	Y3	Y4	Y5
Free Cash Flow Computation						
Profit After Tax	1,078.00	1,369.29	1,599.40	1,857.51	2,173.29	2,542.74
Depreciation	8.40	10.23	11.25	12.38	13.87	15.53
Other Amortisations	10% 107.80	136.93	159.94	185.75	217.33	254.27
Gross Free Cash Flow	1,194.20	1,516.45	1,770.58	2,055.64	2,404.48	2,812.55
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Total Free Cash Flow	1,194.20	1,404.87	1,640.40	1,904.58	2,227.92	2,606.17

Depreciation and amortisations are added back since they are non-cash items appearing in the P&L account. 'Changes in working capital' is either a deduction or an addition depending upon whether the net working capital has increased or decreased during the year. Capital commitments (capital expenditure) are the normal capital expenditure requirement on an on-going basis. Such on-going capex and working capital investments are required in any business and are known as reinvestment requirements. These are subtracted along with debt repayments (if any on long term account) from the operating cash flow generated during the year to arrive at the free cash flow.

Step 2 – The Terminal Value

The terminal value of the free cash flow (FCF) after the forecasted period is the last leg for future cash flow determination. This is calculated to perpetuity to capture the value of the cash flow that accrues after the forecasted period. It is calculated by considering the FCF for the T+1 year if 'T' is the last year of the forecasted period. The FCF of the T+1 year is then valued to perpetuity as follows –

$$\text{Terminal Value of FCF} = \frac{\text{FCF}_{T+1}}{\text{WACC} - g}$$

Wherein 'g' is the expected growth rate of PAT after the discrete period and 'WACC' is the weighted average cost of capital.

Step 3 – Determination of Cost of Capital

The DCF method requires the adoption of a weighted average cost of capital (WACC) which will be used to discount the cash flow to arrive at its present value. The WACC is estimated by taking the individual post-tax cost of debt and the cost of equity separately and multiplying them in the ratio of debt to equity in the capital structure. The cost of debt is considered at the average carrying cost in the balance sheet or the marginal cost of borrowing whichever is appropriate for the company. The cost of equity is usually based on the Capital Asset Pricing Model (CAPM) but is adjusted to reflect the illiquidity premium of alternative assets and further specific risk premium if any applicable to the given company. Accordingly, the cost of equity of an unlisted company will be higher than that of a comparable listed company. The concept of WACC is illustrated in Box 14.1.

Box 11.1: COMPUTATION OF WEIGHTED AVERAGE COST OF CAPITAL (WACC)

Let us consider the Cost of long-term debt capital of a company is 12.5% pre-tax. Assuming a tax rate of 30%, the post-tax cost of debt is 8.75% (i.e. $12.5 \times (1-0.3)$) considering the tax shelter provided by the interest paid on the loan. With the help of CAPM (adjusted for any specific risk premium on the company), let us consider the Cost of Equity is determined at 17.5%.

The WACC will be based on the Debt-Equity Ratio (DER) of the company. If the DER is say, 1.5:1, it means the debt percentage in the total capital structure is $1.5 / 2.5 = 60\%$. Hence equity = 40%. Therefore, the cost of debt will be $8.75 \times 60\% = 5.25\%$. The cost of equity would be $17.5 \times 40\% = 7\%$.

The WACC would be arrived at by adding the two components, i.e. $5.25\% + 7\% = 12.25\%$

The computation of DCF value based on the above discussion is provided below in Step 4 for the data already computed under Step 1.

In the given computation below, the WACC is considered at 11.35% based on separate consideration of the cost of debt (k_d) and the cost of equity (k_e) at the appropriate weightages based on their ratio in the capital structure. The terminal growth rate has been assumed at 5%. Normally terminal growth rates for consolidated industries are considered at 2-3% above the inflation rate. Therefore, if inflation is 3%, the growth rate could be about 5-6%. In high growth or sunrise industries which are expected to maintain significant growth for a long period of time, there is a justification to take higher terminal growth rates. The consideration of the terminal growth rate is very significant as it influences the value of shares almost all by itself in young companies. Since venture capital funds and private equity funds deal with young and growing unlisted companies, the terminal growth rate could be an important parameter for the investor to consider if DCF analysis is being used to measure the value of the company.

Step 4 – Arriving at DCF Value of an Equity Share

DCF Valuation (in Rs. Lakh)	Y1	Y2	Y3	Y4	Y5	TVF
Explicit forecast period	1	2	3	4	5	6
WACC	11.35%					
Discount factor	0.8980	0.8065	0.7242	0.6504	0.5841	0.5245
FCF	1,404.87	1,640.40	1,904.58	2,227.92	2,606.17	
PV of FCF	4,151.26	1,261.62	1,322.92	1,379.35	1,448.99	1,522.16
Continuing value						
Terminal growth rate of FCF	5.00% Assumption					
Terminal Value	43062.54					
PV of TV	22586.53					
<u>Value of firm</u>						
Enterprise Value	26,737.79					
Less: Debt (assumed)	1,324.00					
Equity Value	25,413.79					
No. of outstanding equity shares	50					
Value/share (Rs.)	508.28					

In the above computation, the cash flows have been discounted at the WACC and accordingly, the PV of the FCF and the PV of the TV are obtained. The discounting factors (PV factors) for each year are provided in the computation using 11.35% as the discounting rate. The Terminal Value (TV) is calculated as $FCF \text{ of the last year } (Year5 \times (1+g)) / (WACC-g)$. This provides a value of INR 43062.54. This value is discounted at the factor applicable to the TV, i.e. the TVF of 0.5245 to arrive at the PV of the TV.

The sum of the two values provides the Enterprise Value of the company, i.e. PV of FCF + PV of TV.

The Enterprise Value is reduced by the amount of debt outstanding which is assumed above as INR 1324. After the deduction of outstanding debt, the resultant value provides the equity

value of the business. Dividing this value by the number of outstanding equity shares (issued capital as of date) provides the Value per share of the company.

11.7 Relative or Multiple based Valuation

‘Relative valuation’ is an approach that believes that assets and firms have to be valued on the basis of their current market price. The methodology involves the use of certain standardised multiples that can derive value and enable inter firm comparison and value benchmarking. It is due to this reason that this method is known as relative valuation. The popularity of this approach stems from the fact that it is easier to explain and less quantitative than the DCF approach. Relative valuation is widely used by research analysts, transaction bankers, investors, brokers and other market participants, both in the capital market and in the alternative investment space.

For a transaction to be properly priced, it is the current market value that is relevant. Relative valuation becomes the key to address this issue. However, relative valuation suffers from some disadvantages as well – (a) it does not take into account the future capital expenditure and incremental working capital requirements which could have a significant impact on value, (b) it is suitable only when companies have reached maturity and are quite stable in their future outlook, (c) the selection of multiples is subjective and (d) multiples are driven by external factors which could alter a company’s valuation without there being any fundamental shift in its intrinsic value between two given points of time.

Relative valuation is based on multiples that are adopted from two different approaches – (1) ‘Earnings based multiples’ (also known as ‘Transaction Comparables’ or ‘Deal Comps’) and (2) ‘Market based multiples’ (also known as ‘Trading Comps’). In the former category the most commonly used are the EV/EBITDA multiple and EV/Sales or EV/Revenue multiple (also known as ‘topline multiple’). In the ‘Trading comps’ category, the most common are the Price-Earnings Multiple (P/E Ratio) and the Price-Book Value Multiple (P/BV Ratio).

The P/E ratio is the most widely used market related multiple in valuation. However, there are also those firms that are not listed and therefore lack a market price validation. Therefore, for unlisted companies, trading comps are quite unsuitable and at best, current market multiples applicable to listed surrogates may be used to value unlisted companies. To overcome this difficulty, over the years, relative valuation has developed ‘firm value multiples’ as well that determine the value without reference to the market price. Herein we will discuss the important firm value multiples. It may however be noted that, relative valuation methods determine the Enterprise value. In order to arrive at the Equity Value, the book value or market value of outstanding debt has to be deducted from the Enterprise Value.

11.7.1 EBITDA Multiple

The first multiple is the '*Enterprise Value to EBITDA multiple*' that is computed as follows: –

$$\frac{\text{EV}}{\text{EBITDA}} = \frac{\text{Value of Firm}}{\text{EBITDA}}$$

Higher the above multiple, higher is the value of the company.

The advantage of using the EBITDA (Earnings before Interest, Tax, Depreciation and Amortisations) in the place of PAT is that EBITDA is a measure of operational efficiency. Therefore, higher the EBITDA, higher would be the return on investment (ROI) and hence the efficiency of the capital in business. Companies are given higher EBITDA multiples in valuation looking at the above factors. Secondly, in companies where the EBITDA is positive but the profit after tax (PAT) is negative (due to high interest, depreciation and amortisation burden), this multiple provides a better measure of value. This can happen in the case of businesses with long gestation to break-even and profits such as in start-up companies in growth phase or asset heavy businesses.

Illustration 11.6

Considering the Enterprise Value in the DCF illustration above, we can arrive at the EV/EBITDA multiple of the company:

Enterprise Value of the Company = INR 26,737.79 lakh

If the estimated EBITDA for Y1 = INR 1875 lakh

EV to EBITDA multiple = $26737.79 / 1875 = 14.26$

11.7.2 Price to Book Value Multiple

The second model of relative valuation is the '*Price to Book Value multiple*' measured as:

$$\frac{\text{EV}}{\text{Networth}^{96}} = \frac{\text{Value of Firm}}{\text{Networth}}$$

⁹⁶Networth is defined as Net Fixed Assets + Long Term Investments + Net Current Assets – Long Term Liabilities. Alternatively, Networth = Shareholders' Funds, i.e. Share Capital + Accumulated Reserves.

This multiple can be used either with reference to the market value of a company or value determined by any other method such as DCF to understand how many times of its current book value the company is being valued at. Usually, in listed companies, if a company's market value (known as market capitalisation) is 4-5 times of its book value, it is considered a healthy valuation. In unlisted companies, the DCF value can be cross-checked with the book value multiple. However, in start-ups and other technology companies where book value could be negative, this multiple cannot be used.

Illustration 11.7

In a start-up company, the financing is usually made by equity share capital since there may not be any tangible assets to secure against debt financing. Investors usually value the company at a premium benchmarking against future cash flows. Such premium is shown in the reserves of the company. So, at the time of financing, the company shows a positive net worth and book value of share based on the subscribed capital and the securities premium.

Such companies take time to show profits since they may be using their cash mainly to develop products or market by incurring huge costs. So, it is customary for such companies to incur huge losses in the initial years till the business generates sufficient revenues to absorb the costs of operations. As the company keeps making losses, the accumulated losses would wipe out the reserves and may even erode the nominal value of the subscribed capital. Thus, the book value of the share can become negative.

11.7.3 Price to Earnings Multiple

This multiple is used extensively in determining the market valuation of stocks in listed companies as the price used in this metric is the current market price of the share of a company. Therefore, the P/E multiple is a very useful market metric to gauge the value of a company as a multiple of its current earning capacity. It can also be used sometimes to compare unlisted companies in alternative space to their listed peers to know the range at which they are being valued.

Illustration 11.8

Alpha Ltd has an after-tax profit of INR 100 lakhs and a paid-up capital of INR 200 lakhs divided into 20 lakhs shares of INR 10 each. It currently trades at a P/E multiple of 32. What is the current market price of the share?

Earnings Per Share (EPS) of the company = $10,000,000 / 2,000,000 = \text{INR } 5$

Price-Earnings (P/E) ratio = 32

Current Market Price (CMP) = $32 \times 5 = \text{INR } 160$ per share

A few more variations that can be used in the multiple based valuation approach are the PAT multiple (Value of Firm / PAT) and the Earnings before interest and Tax (EBIT) multiple (Value of Firm / EBIT).

In early-stage companies and certain other technology or service based companies, non-financial multiples may also be used. In e-commerce, the GMV multiple (gross merchandise value) is used. In telecom the ARPU (average revenue per user) is used. In the hotel industry, the ARR (average room revenue) is used sometimes. Multiples approach is very useful to validate the valuation arrived at by a different approach as it can easily be compared against peer companies both in the listed and unlisted categories as well as to industry benchmarks.

11.8 Valuation of AIF Portfolio Investments (Investee Companies)

Based on the above discussion, it is evident that there are multiple approaches to the valuation of an investee company's business and accordingly, the value of the portfolio held by the AIF in that company would also be subject to variation based on the method adopted. There are also five other major contributors to the change in value of an investee company. These are as follows –

1. Changes in external environment and market variables that may take the prevailing valuations up or down.
2. Changes in the business performance of the investee company.
3. Changes in the tax environment that may impose additional burden or reduce existing tax liability on the investee company.
4. Changes in the capital structure of the company due to increase or decrease in debt/equity capital.
5. Changes adopted in valuation methodology.

It must be noted that all valuations, regardless of the method in use, have certain principles:

1. **Valuation is time specific.** The value of a business changes every day and depends on various factors such as the cash flow, earnings, working capital, among others.
2. **Value depends on future cash flows.** These are primarily done by calculating the present value of these future cash flows, as per the Discounted Cash Flow Method discussed above.
3. **Certain market forces dictate the rate of return** which is used to calculate the present value. These include the general economic conditions and external global factors.

4. **Liquidity affects the value of a company.** With the increase in the liquidity of a company, its value increases as well since these liquid assets act as a security for the stockholders in case of likelihood of bankruptcy.

11.8.1 Valuation Metrics

There are many valuation metrics used for start-up valuation and performance assessment. These measures are useful for both investors as well the entrepreneur to track the growth rate. Some of the metrics are listed below:

Revenue Growth and Customer Retention:

- A. **Monthly Recurring Revenue (MRR):** MRR is crucial for subscription-based businesses. It measures the total recurring revenue generated each month by the company. A consistently growing MRR indicates a healthy and scalable business model.
- B. **Annual Recurring Revenue (ARR):** ARR is the yearly equivalent of MRR and represents the predictable revenue generated annually.
- C. **Customer Lifetime Value (CLTV):** CLTV represents the total revenue generated from a customer over their entire relationship with the start-up. CLTV is computed as the average purchase value of customers and multiplied by the average number of purchases made by the customers.
- D. **Customer Acquisition Cost (CAC):** CAC measures the average cost of acquiring a new customer. A lower CAC indicates efficient marketing and sales techniques, which can ensure long-term sustainability and scalability.
- E. **CLTV/CAC Ratio:** It is always advised to check the ratio of CLTV and CAC so that comparisons can be made between two different companies in the same industry. For example, a company has a customer acquisition cost of USD 50 and the lifetime value of each new customer is USD 250, then its CLTV/CAC ratio is 5x.
- F. **Churn Rate:** Churn rate is the percentage of customers who discontinue using a product or service over a given period. This metric is crucial to ensure that the investee company is in a sustainable business environment.
- G. **Daily Active Users (DAU) / Monthly Active Users (MAU):** DAU and MAU measure the number of unique users who engage with a product or service daily or monthly, respectively. This shows the customer's loyalty to the company.
- H. **Net Promoter Score (NPS):** NPS gauges customer satisfaction and loyalty by asking how likely they are to recommend the product or service to others. A high NPS implies a strong brand reputation and customer advocacy. NPS is calculated by subtracting the percentage of customers who answer the NPS question with a 6 or lower (known as detractors) from the percentage of customers who answer with a 9 or 10 (known as promoters).
- I. **Viral Coefficient:** It represents the degree of exponential growth which a company experiences, by analyzing the number of referrals sent per user, the conversion rate

of those referrals, and the total number of current users. This metric is used in industries wherein word-of-mouth marketing strategy can be efficiently deployed. For example, a start-up determines that on average, each user sends out three referrals for new users to join and the conversion rate of those referrals is 33%. This indicates that three existing user can get one more paid user, on average.

Financial Metrics:

1. **Burn Rate:** Burn rate is the rate at which a start-up spends its cash flows. It is essential to control the burn rate for maintaining financial stability and a good runway for future expenses.
2. **Operating Cash Flow:** Operating cash flow measures the cash generated from a start-up's core business operations. Positive operating cash flow is vital for long-term sustainability and growth.
3. **Contribution Margin After Marketing:** The Contribution Margin is simply computed by deducing the variable costs per order, from the revenue per order. However, direct marketing expenses incurred should also be deducted to arrive at the Contribution Margin, which gives a more efficient analysis of unit economics and the control over marketing expenses.
4. **Return on Investment (ROI):** ROI measures the profitability of an investment relative to its cost. Investors in start-ups look at very high ROI over longer tenures.
5. **Employee Productivity:** Revenue Per Employee or Employee productivity is the output generated per employee.
6. **Customer Conversion Rate:** Once visitors are on your website, the next task is to convert them into customers. Different companies measure conversion in different ways, such as the percentage of visitors placing an order, or signing up for a newsletter or clicking on a Call-to-Action button on the landing page. This can be derived by dividing the number of sign-ups per month by the monthly unique visitors.
7. **Average Order Value:** This is the average revenue per order, which is derived by dividing the total revenue per year, by the total number of orders placed in that year. This gives great insights into how many free products or services are being given by the company, to generate revenue.

11.8.2 Pre-money and Post-money Valuation for Start-ups

Pre-money valuation refers to the estimated value of a start-up immediately before it receives external funding from a Category I AIF or a Category II AIF. The value of the company is based on its existing assets, IPR, market size, team expertise, and other relevant factors. The pre-money valuation, along with the investment amount, is used to calculate the investor's ownership stake in the company after the investment round.

Post-money valuation is the pre-money valuation of a start-up plus the potential investment to be made in the company. This reflects the overall worth of the company including the new investment. The post-money valuation determines the ownership percentage of AIF investing in the company, as well as the founders and/or early investors, after the new investment is made by the AIF.

Understanding the Pre-money Valuation and Post-money Valuation is essential for the Category I AIF and Category II AIF, as well as the founders of the start-up. If the AIF decides to invest a fixed amount in the start-up based on Post-money valuation, the stake in the company will be reduced substantially. For example, ABC Venture Fund wants to invest INR 1 crore in Co. XYZ for a 10% stake, at a Post-money Valuation of INR 10 crore. In this example, the Pre-Money Valuation is INR 9 crore, which is Post-Money Valuation of INR 10 crore – INR 1 crore of new investment.

11.8.3 The IPEV Valuation Guidelines⁹⁷

AIF managers are required to carry out periodic valuations of portfolio investments as part of the reporting process to investors in the funds they manage. The International Private Equity and Venture Capital Valuation Guidelines (IPEV Guidelines) is one such set of guidelines that outline recommendations, intended to represent current best practices, on the valuation of unlisted equity investments.

The basic objective of the IPEV Guidelines is to provide high-quality, uniform, globally-acceptable, principles-based valuation guidelines for private equity and venture capital industry (category I and II AIFs) so as to bring in consistency and harmony in valuation practices, irrespective of size and composition of portfolio.

The central theme of IPEV recommendations is that ‘fair value⁹⁸ is the best measure of valuing private equity portfolio companies (from manager’s perspective) and at fund level (from investor perspective). The Board’s⁹⁹ support for fair value is based on the merit of transparency that the fair value approach provides in portfolio and accordingly, fund valuation.

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<https://www.privateequityvaluation.com/Portals/0/Documents/Guidelines/IPEV%20Valuation%20Guidelines%20-%20December%202022.pdf>

⁹⁸ Fair Value is recognised internationally as the arm’s length price or the price agreed upon between a willing buyer and seller who are not connected to one another. In Indian Accounting Standards (IND-AS 113) Fair value is defined as “the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date”.

⁹⁹ The IPEV Valuation Guidelines are issued by the International Private Equity and Venture Capital Valuation Guidelines Board.

The International Private Equity and Venture Capital Board (IPEV Board) entered into an understanding with the International Valuation Standards Council (IVSC) with the objective of promoting consistency between the IPEV Board's Valuation Guidelines and the IVSC's International Valuation Standards (IVSs). In summary, the IPEV Guidelines identify seven different 'most widely used' methods available to value a portfolio company.

1. **Price of previous transaction** – When the AIF makes a follow-on investment in a company, the pricing thereof becomes the implied market value of the company which can be applied to the entire investment. However, for the first investment, it needs to be carried at cost at that time and revised thereafter, based on pricing of follow-on investments.
2. **Early-Stage Companies** - Many seed, start-up or early-stage investments are valued using a milestone approach, or scenario analysis. For these enterprises, typically, it is difficult to gauge the probability and financial impact of the success or failure of development or research activities and to make reliable cash flow forecasts. Consequently, the most appropriate approach to measure fair value may be a valuation technique that is based on market data, and market participant assumptions as to the potential outcomes. The **option pricing method (OPM)** is also used sometimes which is a forward-looking method that considers the current equity value and then allocates that value to the various classes of equity considering a continuous distribution of outcomes, rather than focusing on distinct future scenarios.
3. **Multiples Approach** - These are commonly used for profit-making companies. Each of the financial multiples may be computed using historical, 'sustainable' or projected data. It is usual to use comparable ratios derived from the quoted markets and/or relevant recent transactions. Having decided which of the potential comparable market ratios to use, it is normal to apply a discount to the quoted market ratio to reflect illiquidity discount applicable to unlisted stock. This discount may be reduced if a fund manager believes an exit to be imminent.
4. **Net asset valuation (NAV)** - Where the investee company is not performing satisfactorily and incurring losses, or it is in the business of finance and investments, it may be valued by reference to its net tangible assets.
5. **Discounted cash flow (DCF)** - DCF is recommended to be used because it has the strongest theoretical underpinning. But DCF models are very sensitive to the assumptions made regarding discount rates and cash flows. Therefore, they need to be used when sufficient data is available to make realistic assumptions.
6. **Valuation of Debt Investments** –DCF of the future cash flows would be a good way of valuing such entities or debt instruments. The same approach may be used for

sub-ordinate debt, mezzanine capital and preference share investments which have predictable cash flows. Non-performing collateralised Debt Investments are often valued based on the value of underlying collateral, the risk of converting the collateral into cash, and the time required to convert the collateral into cash. Uncollateralised non-performing Debt Investments or Debt Investments expected to be restructured because the Investee Company is a going concern, are valued based on the most likely cash flows discounted at the rate applicable to a market purchaser of such debt. In other words, it shall be the cost of capital at which the purchaser of such distressed debt would discount the debt.

7. **Industry Metrics** – This approach is ideal to incorporate non-financial metrics as explained earlier in this Chapter. Some industries such as e-commerce, telecom, hospitality etc. have commonly quoted metrics that are not based on cash generation or profitability. Multiples of sales are often quoted for companies that are either loss making or where profits are not disclosed. Similarly, the growth of new subscriber businesses was characterised by the use of ‘value per subscriber’. All of these methods are proxies for the future cash generation that will accrue from the business. In general, the further the valuation metric moves away from being based upon future cash generation, the greater the likelihood that it will be proved to be inaccurate.

11.9 General Approach to Fund Valuation

Fund valuation refers to the valuation of the aggregate value of the corpus of a fund or a scheme therein from time to time. Investors in unit capital of an AIF trust or in partnership interests of an AIF LLP would need to assess their position periodically based on the value of the total fund and accordingly, the value of their proportionate interests therein.

Generally, the net asset value (NAV) of the fund represents its total value and the value of the unit capital or partnership interest of an investor as the proportionate value thereof. NAV (Fair value) of a fund is equivalent to the sum of the estimated fair value of underlying portfolio investments of the AIF as on the valuation date. This type of valuation is known as the ‘**sum of parts valuation**’ method and in AIF parlance, it is known as the ‘**bottom-up approach**’ whereby the NAV of each portfolio asset is added up from bottom to the top as of the valuation date. However, the fair value of an investor interest would be equal to the proportionate distributable NAV of the fund as of that date after deducting taxes and statutory payments if any, outstanding fees and expenses, carried interest and other contractual deductions.

Therefore, NAV of the fund, when derived as the 'Fair Value' of underlying investments and adjusted for payables and deductions as of that date, provides the best indication of the cash flows an investor would receive at the valuation date and thereby a best measurement of the value of the investor's fund interest. This concept is particularly appropriate for Category I and II AIFs that are close-ended and investors are meant to realise cash returns on their fund interests only when realisation events occur through the sale of the underlying portfolio companies.

It may however be noted that the NAV of the fund estimated on the lines mentioned above may itself be subject to adjustments and revisions from time to time based on movements in the underlying value of portfolio investments, subsequent transactions such as realisations, external factors or change in valuation methodologies. In a nutshell, the value of a fund is the 'Adjusted NAV' of the underlying investment portfolio such that it is equivalent to the amount of cash that would be received by the investors as if all underlying portfolio of investee assets were realised as at the valuation date.

11.9.1 Fund Valuation and the J curve

Reference may be made here to the J Curve discussion made in Chapter 9. In the early stages of a fund, the fund NAV would decline to negative zones and as the fund progresses and reaches its maturity years, the NAV tends to climb. This makes it particularly difficult to assess the true NAV in the early years of the fund as too many underlying investments are yet to grow and the underlying NAVs may not be adequately representative of future outcomes in cash flow. In other words, the component of unrealised investments as a percentage of total fund value is high in the initial years. Therefore, the variance factor could be significant. But as the fund advances, makes realisations and reaches its maturity years, the valuations of the portfolio assets become more predictable and the NAV of the fund may converge more closely with its ultimate gross realisations.

11.10 Net Asset Value (NAV)

As per SEBI (Alternative Investment Funds) Regulations, every AIF shall ensure that calculation of the Net Asset Value (NAV) is independent from its fund management function. NAV calculated on each 'Valuation Day' shall be disclosed to all investors on a quarterly basis for closed-ended AIFs. AIF investors are to be provided with a description of the valuation procedure, the methodology of valuation and changes to such valuation methodology, if any.

11.11 Valuation Regulations¹⁰⁰

Regulation 23 of the SEBI (AIF) Regulations states that all AIFs shall ensure that valuation of investments are done in the manner specified by SEBI from time to time. It further provides that:

1. The AIFs shall provide to its investors, a description of its valuation procedure and of the methodology for valuing assets.
 - a. Valuation of securities, other than unlisted securities and listed securities which are non-traded and thinly traded, for which valuation norms have been prescribed under SEBI (Mutual Funds) Regulations, 1996 shall be carried out as per the said Regulations.
 - b. Valuation of securities, for which no valuation norm is prescribed under SEBI (Mutual Funds) Regulations, shall be carried out as per valuation guidelines endorsed by any AIF industry association, which in terms of membership represents at least 33% of the number of SEBI registered AIFs. Such industry association shall endorse appropriate valuation guidelines after taking into account recommendations of Alternative Investment Policy Advisory Committee (AIPAC) of SEBI.
 - c. The PPM of AIFs shall contain details of the valuation methodology and approach adopted for each asset class of the scheme.
2. Category I and Category II AIFs shall undertake valuation of their investments, at least once in every six months, by an independent valuer appointed by the AIF. The period may be enhanced to one year on approval of at least seventy-five percent of the investors by value of their investment in the AIF.

The valuation of underlying portfolio of AIF assets and accordingly, the fund valuation are an important compliance and disclosure requirements under the AIF Regulations. The emphasis on external independent valuations also needs to be noted.

Change in methodology/ approach within the valuation guidelines/ valuation norms prescribed for AIFs, should not be construed as a 'material change'. However, valuation based on both old and new methodologies should be disclosed to the investors to ensure transparency.

¹⁰⁰ Vide SEBI (AIF) (Second Amendment) Regulations, 2023 w.e.f. November 1, 2023 and SEBI Circular No.: SEBI/HO/AFD/PoD-1/P/CIR/2024/123 dated September 19, 2024 on Modification in framework for valuation of investment portfolio of AIFs.

11.12 Role of third-party Registered Valuers

Under SEBI (Alternative Investment Funds) Regulations, 2012, all AIFs shall ensure that valuation of investments are done in the manner specified by SEBI from time to time. All AIFs should provide the description of its valuation procedure and methodology for valuing assets to its investors.

Category I and Category II AIFs should value their investments atleast once every 6 months, by appointing an independent registered valuer. The frequency of such valuation can be extended to 1 year, with approval of 75 percent of the investors by value of their investments in such AIFs.

The Investment Manager shall appoint an independent valuer, which satisfies the following eligibility criteria:

- The independent valuer shall not be an associate of manager or sponsor or trustee of the AIF.
- The independent valuer shall have at least 3 years of experience in valuation of unlisted securities.
- The independent valuer shall fulfil one of the following criteria:
 - The independent valuer is a valuer registered with Insolvency and Bankruptcy Board of India (IBBI) and has membership of Institute of Chartered Accountants of India (ICAI) or Institute of Company Secretaries of India (ICSI) or Institute of Cost Accountants of India (ICMAI) or CFA Institute; or
 - The independent valuer is a holding company or subsidiary of a Credit Rating Agency registered with SEBI; or
 - Any other criteria may be specified by SEBI.
- The eligibility criteria for independent valuer for a partnership entity or company shall be as follows:¹⁰¹
 - Such entity or company shall be a Registered Valuer Entity registered with IBBI; and
 - The deputed/ authorised person(s) of such Registered Valuer Entity, who undertake(s) the valuation of investment portfolio of AIFs, shall have a membership of ICAI or ICSI or ICMAI or CFA Charter from the CFA Institute.

The Manager and the key management personnel of the AIF shall ensure that the independent valuer computes and carries out valuation of the investments of the fund in the manner specified by SEBI from time to time. The investment manager shall be responsible for a true and fair valuation of the investments of the AIF. In case the valuation

¹⁰¹SEBI Circular No.: SEBI/HO/AFD/PoD-1/P/CIR/2024/123 dated September 19, 2024 on Modification in framework for valuation of investment portfolio of AIFs.

policies and procedures of the AIF do not result in fair and appropriate valuation, the Investment Manager shall deviate from such policies to value the assets or securities at a fair value and document the rationale for such deviation. In this regard:

- At each asset level, in case of deviation in valuation of more than 20% between two consecutive valuations or a deviation of more than 33% in a financial year, the Investment Manager shall inform the investors with reasons for the same. This information shall include both generic and specific information, including but not limited to changes in accounting practices or policies, assumptions or projections, valuation methodology and approach, with reasons thereof.
- Any change in the valuation methodology or approach shall be construed as a material change significantly influencing the decision of the investor to continue to be invested in the AIF scheme. In such circumstances, the AIF must ensure compliance with guidelines issued by SEBI on disclosure and reporting requirements.
- The Investment Manager shall disclose the following as part of changes in PPM to be submitted annually to SEBI and investors:
 - Details of changes in the valuation methodology and approach, if any, for valuation of each asset class of the AIF scheme.
 - Details of changes in accounting practices/policies, if any, of the investee company and AIF scheme.
 - Details of impact of the aforesaid changes in terms of valuation of the investments of the AIF scheme.

Sample Questions: Chapter 11

1. Which of the following metric measures the estimated value of a start-up immediately before it receives external funding from a Category I AIF or a Category II AIF?
 - a. Post-money Valuation
 - b. **Pre-Money Valuation**
 - c. Net Asset Value
 - d. Enterprise Value

2. _____ is the percentage of customers who discontinue using a product or service over a given period
 - a. Customer Acquisition Cost
 - b. Customer Lifetime Value
 - c. **Churn Rate**
 - d. Burn Rate

3. Sum of the parts (SOTP) valuation in AIF context means:
 - a. The AIF portfolio is divided into various similar parts and valued together
 - b. **The underlying AIF investee companies are valued separately and their value is added up.**
 - c. The portfolio companies are valued first and added to the value determined for the AIF.
 - d. AIF is valued at fund level and investee companies are valued at portfolio level. Both the values are added to get the SOTP value.

4. EV/EBITDA value of a company provides the enterprise value of the company and not its equity value. State whether True or False.
 - a. **True**
 - b. False

5. In determination of the valuation of an AIF fund under the Bottom-Up approach, the equity value of the investee companies is used. State whether True or False.
 - a. **True**
 - b. False

CHAPTER 12: FUND MONITORING, REPORTING AND EXIT

LEARNING OBJECTIVES:

After studying this chapter, you should know about:

- Importance of fund performance monitoring and reporting
- Regulatory framework for fund monitoring and reporting
- Various exit strategies adopted by AIFs
- Winding up procedures of an AIF

12.1 Monitoring Alternative Investment Fund Progress and Performance

Considering the basic nature of alternative investments (long-term and illiquid), investors may assume that there is little to be done during the fund cycle once the due diligence process has been completed and the commitment to the fund has been made. This is far from the truth. Ongoing fund monitoring throughout its life cycle is a necessary control mechanism. While investment managers perform their duty of maximising returns at fund level by regularly making, monitoring, nurturing and exiting underlying investments, it is necessary for them to report the fund performance on an on-going basis to investors.

12.1.1 Context and Scope of Effective Fund Monitoring

Fund monitoring should be seen as part of a larger control system within the investment process. Because of the illiquidity of an AIF, the investor's ability to react to different situations is somewhat limited. In complex problems, a solution will require finding a consensus with the fund manager and the other co-investors, or building alliances with co-investors to exercise pressure and act jointly. There are other benefits of fund monitoring as well. In the context of a co-investment strategy, monitoring is important for screening interesting investment opportunities that may arise. Lessons learned from monitoring can also be applied in the future to improve the due diligence process and the selection of future investments. So, focus should be both on providing standardised formal reporting information as well as on informal interactions with the investors and the investment committee / board of directors of the fund.

Generally speaking, investing in and monitoring AIF investments involve more effort and higher costs relative to on-market investment funds. AIF investors have to be made aware of the need to be patient and understanding especially during the early years of a fund's lifetime. By the same logic, investors' reaction should not be typically too little, too late, when things need to be addressed urgently to prevent further deterioration of the fund's outcome. So, they need to be goaded to take action in time.

Fund monitoring is an integral part of ensuring compliance with fund objectives, the terms of the contribution agreement and for gathering information. Fund monitoring should not be confused with fund management, an activity in which, in accordance with the contribution agreement, the investors have no involvement. Fund monitoring is an oversight process on overall asset allocation, portfolio composition, fund governance and performance. Investors have to also keep track of internal and external risk factors that may have a bearing on the AIF's working and outcome.

Because of the blind-pool nature of AIF investing, it is crucial for investors to set the risk profile of their investment at the time of commitment. Moreover, given AIF's lack of liquidity, the investor cannot easily adjust portfolio holdings or rebalance them if the manager has to undertake actions that are in variance with fund documentation. It requires effective communication and dialogue between the manager and the investors to seek appropriate redirections. There are risks associated with adhering too closely to a declared investment strategy, especially when market conditions change significantly, creating new opportunities. Investors have to be made aware of the need to keep this aspect in mind as well.

12.2 Regulatory Framework for Fund Monitoring and Reporting

Under Regulation 20 of the SEBI (AIF) Regulations, there is a general responsibility that the AIF shall review policies and procedures, and their implementation, on a regular basis, or as a result of business developments, to ensure their continued appropriateness. This would mean that investment manager as well as its officers need to engage on a regular basis to monitor the fund's policies and performance. In addition, there are specific roles and responsibilities, the most important being those listed below¹⁰²

1. The Manager and either the trustee or trustee company or the Board of Directors or the designated partners of the AIF, as the case may be, shall ensure compliance by the AIF with the Code of Conduct (as specified in the Fourth Schedule to the AIF Regulations).
2. All AIFs shall have detailed policies and procedures, as approved jointly by the Investment Manager and the trustee or trustee company or Board of Directors or designated partners of the AIF, as the case may be, to ensure that all the decisions of the AIF are in compliance with the provisions of the AIF Regulations, terms of the placement memorandum, agreements made with investors, other fund documents, applicable laws and internal policies of the AIF. The Investment Manager shall be responsible for every such decision meeting the aforesaid compliance.
3. The Manager may constitute an Investment Committee (by whatever name called), to approve the decisions of the AIF. Such committee shall function under the

¹⁰²As introduced by the Second Amendment Regulations 2021.

conditions as may be specified by SEBI and shall be responsible for the compliance specified under (2) above¹⁰³.

4. The Sponsor or Investment Manager shall appoint a custodian registered with SEBI for safekeeping of the securities/goods of the fund.
5. The Investment Manager and either the trustee or the trustee company or the Board of Directors or designated partners of the AIF, as the case may be, shall ensure that the assets and liabilities of each scheme of the AIF are segregated and ring-fenced from other schemes of the AIF; and bank accounts and securities accounts of each scheme are segregated and ring-fenced.
6. AIFs shall inform SEBI in case of any material change from the information provided by them at the time of application for registration.
7. In case of change of Sponsor or Investment Manager, or change in control of the AIF, Sponsor or Investment Manager, prior approval from SEBI shall be taken.
8. The Investment Manager shall not provide advisory services to any investor other than the clients of Co-investment Portfolio Manager as specified in the SEBI (Portfolio Managers) Regulations, 2020, for investment in securities of investee companies where the AIF managed by it makes an investment.
9. The Investment Manager shall appoint a Compliance Officer who shall be responsible for monitoring compliance with the provisions of the Act, rules, regulations, notifications, circulars, guidelines, instructions or any other directives issued by SEBI and such compliance officer shall independently report any deviation to SEBI forthwith within 7 working days.

12.2.1 Stewardship Code

A framework on Stewardship Code was introduced for AIFs for mandatory compliance in case of their listed investments that has significance for investment managers. It is based on guiding principles as enunciated by SEBI¹⁰⁴. These principles along with a brief description thereof are furnished below extracted from the circular cited.

1. **Principle 1** – AIFs should formulate a comprehensive policy on the discharge of their stewardship responsibilities, publicly disclose it, review and update it periodically. Stewardship responsibilities include monitoring and actively engaging with investee companies on various matters including performance (operational, financial, etc.), strategy, corporate governance (including board structure, remuneration, etc.), material environmental, social, and governance (ESG) opportunities or risks, capital structure, etc. Such engagement may be through detailed discussions with management, interaction with investee company boards, voting in board or

¹⁰³This requirement does not apply when waivers are issued by SEBI to Large Value Funds meeting specified requirements or in other specific cases.

¹⁰⁴SEBI Master Circular No. SEBI/HO/AFD/PoD1/P/CIR/2023/130 dated July 31, 2023.

shareholders meetings, etc. The policy should be reviewed and updated periodically and the updated policy should be publicly disclosed on the entity's website.

2. **Principle 2** -AIFs should have a clear policy on how they manage conflicts of interest in fulfilling their stewardship responsibilities and publicly disclose it. The policy shall be intended to ensure that the interest of the client/beneficiary is placed before the interest of the entity. The policy should also address how matters are handled when the interests of clients or beneficiaries diverge from each other.
3. **Principle 3** – AIFs should monitor their investee companies continuously which shall be in the form of a policy. The policy shall address the areas and extent of monitoring including situations that do not require monitoring. The policy should also keep in mind regulations on insider trading while seeking information from the investee companies for the purpose of monitoring.
4. **Principle 4** – AIFs should have a clear policy on intervention in their investee companies. Institutional investors should also have a clear policy for collaboration with other institutional investors where required, to preserve the interests of the ultimate investors, which should be disclosed. The policy shall identify the circumstances for active intervention in the investee companies and the manner of such intervention. The mechanisms for intervention may include meetings/discussions with the management for constructive resolution of the issue and in case of escalation thereof, meetings with the boards, collaboration with other investors, voting against decisions, etc.
5. **Principle 5** – AIFs should have a clear policy on voting and disclosure of voting activity. It is critical that the institutional investors take their own voting decisions in the investee company after in-depth analysis rather than blindly supporting the management decisions. This requires a comprehensive voting policy to be framed including details of mechanisms of voting, circumstances in which voting should be for/against/abstain, disclosure of voting, etc.
6. **Principle 6** – AIFs should report periodically on their stewardship activities. Institutional investors shall report to their clients/ beneficiaries periodically on how they have fulfilled their stewardship responsibilities as per their policy in an easy-to-understand format. It may also be placed on their website.

12.2.2 Specific Transparency and Periodic Disclosure Requirements

Under Regulation 22 of the SEBI (AIF) Regulations, all AIFs shall ensure transparency and disclosure of information to investors on the following:

- a) financial, risk management, operational, portfolio, and transactional information regarding fund investments;
- b) any fees ascribed to the Manager or Sponsor; and any fees charged to the AIF or any investee company by an associate of the Manager or Sponsor;

- c) any inquiries/ legal actions by legal or regulatory bodies in any jurisdiction, as and when occurred;
- d) any material liability arising during the AIF's tenure, as and when occurred;
- e) any breach of a provision of the placement memorandum or agreement made with the investor or any other fund documents, if any, as and when occurred;
- f) change in control of the Sponsor or Manager or Investee Company;
- g) any significant change in the key investment team;
- h) AIFs shall provide, when required by SEBI, information for systemic risk purposes (including the identification, analysis and mitigation of systemic risks).¹⁰⁵

Category I and II AIFs shall provide at least on an annual basis, within 180 days from the year end, reports to investors including the following information, as may be applicable to the AIF.

A. Financial information of investee companies

B. Material risks and how they are managed including:

- i. concentration risk at fund level;
- ii. foreign exchange risk at fund level;
- iii. leverage risk at fund and investee company levels;
- iv. realisation risk (i.e. change in exit environment) at fund and investee company levels;
- v. strategy risk (i.e. change in or divergence from business strategy) at investee company level;
- vi. reputation risk at investee company level;
- vii. extra financial risks, including environmental, social and corporate governance risks, at fund and investee company level.

12.2.3 Maintenance of Records

Under Regulation 27 of the SEBI (AIF) Regulations, the Manager or Sponsor shall maintain the following records:

- (a) the assets under the scheme/ fund;
- (b) valuation policies and practices;
- (c) investment strategies;
- (d) particulars of investors and their contribution;

¹⁰⁵Systemic risk refers to business practices that may lead to a wider financial risk for an AIF much beyond a particular investment risk. For e.g. if an AIF is heavily invested in a particular sector and there are sectoral issues, a larger part of the AIF portfolio may face a risk of erosion in value.

(e) rationale for investments made.

All the above records are required to be maintained for a period of five years after the winding up of the fund.

12.2.4 Submission of reports to SEBI

Regulation 28 states that SEBI may at any time call upon the AIF to file such reports, as it may desire, with respect to the activities carried on by the AIF. In furtherance to the regulations, SEBI has prescribed through its various circulars the reporting formats for AIFs on an on-going basis to provide for necessary disclosures mentioned in the preceding paragraphs. All AIFs shall submit report on their activity as an AIF to SEBI on quarterly basis within 10 calendar days from the end of each quarter in the revised format as specified by SEBI.¹⁰⁶ These reports are to be submitted online through SEBI Intermediary Portal.

In addition to the above report, all AIFs are required to intimate SEBI and investors about any changes in terms of PPM and other fund documents. These changes are to be reported on a consolidated manner within 1 month of the end of each financial year.

12.2.5 Compliance Test Reporting (CTR)

To ensure proper compliance and adherence with SEBI (AIF) Regulations and related circulars, the manager of a Category III AIF must prepare and submit a Compliance Test Report (CTR) as per the prescribed format.¹⁰⁷

It may be noted that the CTR has to be submitted by the Investment Manager within 30 days from the end of the financial year, to the Sponsor of the fund and the Trustee, in case of a Trust. The Sponsor/Trustee must intimate their observations and comments, if any, to the Investment Manager within 30 days from the receipt of the CTR. The Investment Manager must incorporate all the necessary changes in the CTR, within 15 days from the date of receipt of observations and comments from the Sponsor/ Trustee. Any compliance violation observed by the Sponsor/Trustees in the CTR must be reported to SEBI at the earliest. Some important points reported in the CTR as mentioned in Table 12.1.

¹⁰⁶ SEBI Circular No. SEBI/HO/IMD/IMD-I/DOF6/CIR/2021/549 dated April 07, 2021 on Regulatory Reporting by AIFs.

¹⁰⁷ SEBI Master Circular No.: SEBI/HO/AFD/PoD1/P/CIR/2023/130 dated July 31, 2023 – Annexure 14.

Table 12.1: Some Important Components of CTR

CTR Disclosure Item	Regulatory Guidelines – Under SEBI (Alternative Investment Funds) Regulations	Disclosure to be made in CTR
Previously submitted information	The investment manager must report to SEBI for any material changes in any information previously submitted.	Whether the AIF has informed SEBI about the changes in information previously submitted to SEBI or if such information submitted was misleading.
Change in the investment strategy	Change in the investment strategy of the scheme has to be made with consent of at least two-thirds of unit holders by value of their investment.	Whether there has been any alteration to the fund strategy during the year and whether necessary approval was sought.
Minimum corpus amount for each scheme	Minimum corpus of any AIF scheme has to be INR 20 crore.	Whether each scheme of the AIF has corpus of at least INR 20 crore.
Minimum Investment Amount from Investors	Minimum investment amount from every investor should be INR 1 crore ¹⁰⁸ .	Whether the fund added any new investors and took investments worth less than INR 1 crore from any investor, during the year.
Continuing interest of Fund Sponsor or Investment Manager	Investment Manager or Fund Sponsor should have a continuing interest of not less than 5 percent of the corpus or INR 10 crore, whichever is lower, in a Category III AIF (2.5% and INR 5 crore respectively for Categories I and II).	Whether the Manager or Sponsor has a continuing interest.
Amount of contribution by the investment manager in the AIF	Investments made by the manager needs to be disclosed to the investors.	Whether the Manager and Sponsor have disclosed their investments in the AIF.
Number of investors in the AIF	An AIF cannot have more than 1000 investors in one single scheme.	Whether each scheme of the AIF adheres to the regulation.

¹⁰⁸ Not applicable to Accredited Investors, as per SEBI (Alternative Investment Funds) (Third Amendment) Regulations 2021.

CTR Disclosure Item	Regulatory Guidelines – Under SEBI (Alternative Investment Funds) Regulations	Disclosure to be made in CTR
Fund raising	An AIF can raise funds only by way of a private placement mechanism.	Whether the AIF has solicited or collected funds only by way of private placement. Specify the method for raising funds.
Private Placement Memorandum	The placement memorandum shall contain all prescribed information about the AIF and the scheme.	Whether the placement memorandum contains all information as specified in SEBI (Alternative Investment Funds) Regulations.
New Scheme	Filing of PPM of the new scheme with SEBI and payment of scheme fees (Does not apply to large value funds floated with Accredited Investors).	Whether the AIF has launched any new scheme and has the PPM been filed with SEBI, within 30 days prior to launch of the new scheme, along with scheme fees.
Investment Conditions and Restrictions	Compliance with investment conditions and restrictions as may be applicable.	Whether the AIF has adhered to the investment conditions and restrictions if any, relating to overseas investments, co-investments, concentration limits, investment in associates and temporary liquid assets.
General Obligations of the Fund	Compliance with general obligations and responsibilities of the AIF.	Whether the AIF has appointed a custodian, whether there has been a change in the Sponsor or Manager of the Fund and if books are audited on an annual basis.
Transparency Norms for the Fund	Ensuring transparency and disclosure of information to investors.	Whether periodic reports (annual for Category I and II) with necessary disclosures have been made inter alia, on financial and operational risks, fees paid to the manager, legal actions and inquiries, breach of PPM provisions and change in

CTR Disclosure Item	Regulatory Guidelines – Under SEBI (Alternative Investment Funds) Regulations	Disclosure to be made in CTR
		control and key management team of the AIF.
Calculation of NAV	Valuation of assets as prescribed by SEBI and reporting the same to Benchmarking Agencies, reporting deviation of value in investments to investors and adhering to eligibility norms for appointing an independent valuer.	The description of Valuation procedure and methodology adopted by an independent valuer shall be disclosed in the periodic reporting by Category I and II AIFs which shall be atleast once in every six months.
Extension of Fund Tenure	Fund tenure of a close-ended AIF can be extended for up to 2 years after seeking approval from two-thirds of the unit holders by value of their investment. ¹⁰⁹	Whether the AIF has extended the Fund tenure up to 2 years. Whether the AIF has sought investor approval.
Conflicts of Interest	The Investment Manager must report all conflicts of interest to investors and implement policies to identify, monitor and mitigate potential conflicts.	Whether any conflicts of interest had arisen in the previous year, between investors and fund constituents.
Dispute Resolution Mechanism	Procedures for dispute resolution, through arbitration or such other mechanisms.	Whether the AIF has laid down procedure for resolution of disputes with investors, through arbitration or any such mechanism as mutually decided with investors.
Winding-up	Compliance with Regulation on applicable ground for winding-up.	In the case of a winding up by investors, whether the AIF has taken approval of 75 percent of the investors in value.

¹⁰⁹Large value funds for accredited investors may be permitted to extend its tenure upto 5 years, subject to approval of two-thirds of the unit holders by value of their investment in the large value fund for accredited investors. – Inserted by SEBI (Alternative Investment Funds) (Fourth Amendment) Regulations 2024.

CTR Disclosure Item	Regulatory Guidelines – Under SEBI (Alternative Investment Funds) Regulations	Disclosure to be made in CTR
Distribution or Sale of Unliquidated Investments	Compliance with Regulation on taking investor approval for making in-specie distribution of unliquidated investments or sale of such investments to a Liquidation Scheme under Regulation 29A.	Whether the AIF has taken approval of 75 percent of the investors in value for compliance with Regulation 29(9) or if the AIF has launched a liquidation scheme by filing a PPM with the Board under Regulation 29A.

12.3 Fund Reporting

Generally, fund reporting templates cover the following aspects of fund performance:

- Economy specific details (macro level) – parameters such as GDP growth, fiscal position, currency rate and interest rate outlook and macro stability.
- Sector specific discussion (micro level, trends etc.) – Brief business performance and outlook of each industry that the AIF is invested into.
- Specific details of deals executed by the fund – Transactions that the fund may have executed during the period of reporting. Transactions may relate to new investments, follow-on investments, debt financing, exits and liquidation of investments.
- Current investment portfolio and investment allocation by the Fund – This is a snapshot of the entire portfolio of the fund or specific scheme at the time of reporting providing break up of funds invested in each company, sector in percentage terms.
- Growth and performance of investee companies and significant developments in the portfolio – A brief profile of each investee company and its progress, new developments in their business, emerging opportunities for the fund in such companies, growth in portfolio value etc.
- Future outlook and deal pipeline during the investing period – If the fund is in the investment phase, the deals in the pipeline including term sheets that may have been signed. Deal discussions in process may also be mentioned if significant progress has been made.
- Exits and exit performance in maturity years – Vintage funds are those that have completed fund close and mature funds are those that are closer to harvesting their portfolio and completing their fund cycle. Therefore, exit prospects and execution

become very important disclosures. Such funds have to report exit prospects from their portfolio companies providing details of return generation on completed exits.

- Changes to the PPM: All changes in terms of the PPM and in the documents of the AIFs shall be intimated to its investors and SEBI on a consolidated basis, within 1 month of the end of each financial year. The intimation shall specifically mention the changes carried-out in the PPM and the relevant documents along-with the relevant pages of revised sections/clauses.
- Investor Charter and Investor Grievance Redressal Mechanism: AIFs are required to bring an Investor Charter to the notice of their investors, in the manner prescribed by SEBI, in order to provide relevant information about the activities pertaining to AIF. This Investor Charter is a document with details of services provided to investors, details of grievance redressal mechanism and responsibilities of the investors at one single place, for ease of reference.

Fund valuation and fund performance are reported in the annual statutory reporting by the AIFs. Annual reporting also includes sections on discharge of Stewardship Responsibilities by the fund managers.

Several AIFs operating in India are gradually falling in line with reporting standards prevalent overseas in terms of international practices as per Global Investment Performance Standards (GIPS) by CFA Institute, Institutional Limited Partners Association (ILPA), the International Private Equity and Venture Capital (IPEV) Valuation Board, or the European Private Equity and Venture Capital Association (EVCA) standard practices.

12.3.1 Conflicts and Concerns in Fund Reporting

Managers may be reluctant to disclose all information to investors and with good reason. Their dilemma is obvious - on the one hand, there is a statutory obligation to disclose information to establish good standards and maintain investor relationship; but on the other hand, further information, especially at a level of detail that allows an independent risk assessment, may potentially impact follow-on fund raising if the fund performance is not progressing well. There is also a rationale for maintaining confidentiality to ensure portfolio companies are protected by data privacy. Managers may be apprehensive that too much information given out could dilute the competitive edge of their portfolio companies or potential deals in the pipeline. In an extreme eventuality, there could be legal complications arising from leakage of proprietary fund information as well.

12.4 Exit Options

12.4.1 Material Changes in the PPM

As per the intent of the AIF Regulations, the PPM is the fundamental disclosure document provided by the AIF to its potential investors. The investor makes the investment decision and enters into the fund documentation following the disclosures in the PPM and incidental due diligence.

Fund documentation albeit sacrosanct for compliance during the life cycle of the fund, is however not written in stone. Some of the commercial terms and even the objectives of the fund may be modified if it becomes clear that the original investment strategy cannot be successfully implemented. The SEBI (AIF) Regulations prescribe that when a fund changes its investment objectives, it needs to inform SEBI and its investors about it. Similarly, investors can influence the fund manager to reduce management fees or even release some of the investor commitments. There may be changes in the fee structure or hurdle rate that may result in higher cost or lower returns to investors. On some occasions, , managers may even reduce the target fund size. Any such change in the PPM disclosures or Fund documentation terms that amounts to a material departure has to be dealt with as provided in the AIF Regulations. material changes may be construed as changes in the fundamental attributes of the fund/scheme.

12.4.2 Change of Sponsor / Investment Manager or Control Therein

One of the key material changes that may also impact an investor's decision to continue in the AIF would be a change in the Sponsor Investment Manager or a change in the control of either of such entities. A change of control is defined as follows in the AIF Regulations –

1. If the sponsor or manager is a listed or an unlisted company, 'control' it shall include the right to appoint majority of the directors or to control the management or policy decisions exercisable by a person or persons acting individually or in concert, directly or indirectly, including by virtue of their shareholding or management rights or shareholders' agreements or voting agreements or in any other manner.
2. If the sponsor is any other entity, 'control' shall be construed as any change in its legal formation or ownership or change in controlling interest wherein 'controlling interest' means an interest, direct or indirect, to the extent of not less than fifty percent of voting rights or interest.

In terms of Regulation 20(13) of AIF Regulations, in case of change of Sponsor or Manager, or change in control of the AIF, Sponsor or Manager, prior approval from the Board shall be taken by the AIF.

Manner of Dealing with Material Changes/ Change of Control

Material changes significantly influence the decision of the investor to continue to be invested in the AIF. In extreme situations, the investment management agreement may be terminated by invoking termination rights. However, investors should avoid defaulting on their commitments as it constitutes a contractual breach of the subscription agreement. In order to provide investors with a better situation for such eventualities, the AIF Regulations provide for a mandatory exit option to investors for any of the reasons specified in 15.4.1 or 15.4.2 above¹¹⁰. This provision is applicable to close ended funds. However, such exit process shall not apply in cases where the AIF has obtained the approval of not less than 75% of unit holders by value of their investment in the AIF.

They shall include, but not be limited to the following. The prescribed exit process is discussed below:

Existing unit holders who do not wish to continue post the change shall be provided an exit option. The unit holders shall be provided not less than one month for expressing their dissent.

In case the scheme of the AIF is close-ended, the exit option may be provided as under:

- The exit option shall be provided by buying out of units of the dissenting investors by the manager/ any other person as may be arranged by manager.
- Prior to buying out of such units, valuation of the units shall be undertaken by 2 independent valuers and the exit shall be at value not less than average of the two valuations.
- The responsibility to provide exit to the dissenting investors shall be on the manager. The expenses for the entire process shall be borne by the manager/ sponsor/ proposed new manager or sponsor and shall not be charged to the unit holders.
- The entire process of exit to dissenting investors shall be completed within 3 months from the date of expiry of last date of the offer for dissent.

The trustee of AIF (in case AIF is a trust)/ sponsor (in case of any other AIF) shall be responsible for overseeing the process, ensuring compliance and regularly updating SEBI on the developments.

¹¹⁰SEBI Circular No.: CIR/IMD/DF/14/2014 dated June 19, 2014, further clarified through Circular NCIR/IMD/DF/16/2014 dated July 18, 2014 (subsumed into Master Circular SEBI/HO/AFD/PoD1/P/CIR/2023/130 dated July 31, 2023).

12.4.3 Commercial Exit from Investee/ Portfolio Companies

On an average, AIF investment horizon in portfolio companies could range from 3 years to 7 years or slightly more depending upon the category of AIF, maturity profile of the fund cycle and market conditions. The AIFs need to sell out even if they see further appreciation in value if they are in the winding down phase of the scheme / fund. Of course, fund life may be extended for upto 2 years subject to approval by two-thirds of the investors by value of their investment in the fund. In absence of consent from the investors to either launch a liquidation scheme (detailed in a subsequent para) or for in-specie distribution of the unliquidated investments of an AIF, then the unliquidated investments of the shall be mandatorily distributed to investors in-specie.

The exit strategy from a portfolio company is a long-drawn and complex process and the investment managers have to develop the strategy very carefully for each of the fund investments. In general, the exit options comprise the following routes:

- **Offer for Sale through an Initial Public Offer (IPO)** – This exit is by and large considered the most preferred and attractive exit option for an equity-oriented AIF and has historically yielded the best returns. The AIF makes an offer for sale (secondary share sale) of its holdings in the company in the IPO market thereby encashing its investment at the IPO price. In the event the AIF has not entered its winding up phase, it may opt for a partial exit through the IPO and plan for a gradual complete exit through the secondary market post-listing of the stock. This can happen when their fund cycle is on-going and the fund manager is in a position to wait for a better exit prices in the secondary market. IPOs are long drawn and market-sensitive transactions that require advance planning, timing and execution expertise. The investment manager has to engage with the company, controlling shareholders or promoters and investment bankers to execute the strategy successfully.
- **Secondary Sale (Trade Sale)** – Under this exit option, the investor exits through a secondary stake sale to a third party. The third party could be another AIF which takes over the selling AIF and assumes its position in the portfolio company. This transaction is thus known as ‘trade sale’ or ‘secondary sale’. In a secondary sale, it is customary to find a VC fund being taken over by a later stage PE fund or an earlier PE being taken over by a later PE investor. This transaction is appropriate when the IPO option is not feasible due to adverse market conditions and the AIF wishes to exit the company due to the completion of its investment horizon.
- **Strategic Sale (M&A Exit)** – This option is similar to the secondary sale option except that in this case, the buyer is a corporate buyer either in the same industry (as a competitor) as that of the portfolio company, or a larger company looking for an entry into that industry. Strategic buyers usually acquire stakes of existing shareholders or sometimes the entire company as part of a business acquisition or for other strategic purposes. M&A exits could provide substantial strategic premium

to the sellers depending upon the extent of stake being sold and the status of the investee company in the given industry. This exit is usually the second most preferred exit option after the IPO exit option.

- **Corporate / Promoter Buy back** – A buyback happens when the AIF exercises a ‘put option’ on the shares being held by it in the investee company.¹¹¹ The buyback can be made by the company or the promoters depending upon whom the put option is exercisable on. Buyback by the investee company works well in the AIF context of dealing with unlisted companies since listed companies have a lot more regulatory hurdles in such a process. Even in the case of unlisted companies, there are provisions of law that need to be complied with. Buyback by promoters warrants huge personal / affiliate resources of the promoters to be used in the process. In many AIF backed companies, promoters are not resourceful enough for honouring a put option on them. Furthermore, AIFs usually stipulate a stiff put option exit price for a buyback to compensate for their loss of an IPO exit opportunity. Put options’ price determination is usually specified as a formula in the definitive agreements so as to avoid ambiguity at the time of the transaction. In large cases, put prices guarantees a certain return or IRR to the investor in the said company as agreed upon earlier. The promoters may stipulate that the ‘put’ shall be a residual option not exercisable unless the company does not go public within an agreed time frame or the AIF could not avail of other exit mechanisms stated above. These are the reasons why a buyback option may not be a feasible option in every case. It is usually used as a last resort in a going concern context.
- **Corporate Liquidation**– This is the least preferred and worst case exit option. Liquidations are statutory processes that take a long time to completion and would only provide salvage value if any, to the AIF. In most liquidation situations, the investee company would have become bankrupt and liquidation is only a statutory mechanism to dissolve the company. Normally a ‘liquidation preference’ right could exist to protect the AIF’s first right of exit if the shares in question are preference shares. Usually, a liquidation preference clause might state that the AIF has a right to recover the invested amount along with accumulated dividends in preference to other shareholders. Sometimes, it may provide for 1.5x or 2x right of preference meaning that in the distribution of the liquidation proceeds, the AIF should be given twice its investment before any surplus can be distributed to other shareholders. A third way could be to provide a right to participate in the surplus remaining after taking out their money. Some AIFs decide to protect their right of first exit on liquidation by keeping the investment as venture debt which has priority over equity.
- **Pure Debt Fund Exits**– Pure debt AIFs take the position of secured / sub-ordinate secured / unsecured creditors in investee companies. Their exits are protected by

¹¹¹‘Put Option’ is a contractual right that may be available by specific terms of an investment agreement. Under this arrangement, the buyer of a security shall have the right (but not the obligation) to sell the security back to the seller as per the terms of the agreement.

the debt covenants in their investment agreements that provide for periodic servicing of the debt from the operating cash flow of the company. Such covenants may also include other protections such as charge on assets of the company, collaterals and other credit enhancements. All these arrangements are designed to return the debt capital along with the stipulated return. In some situations, the debt could have a convertibility option that would enable the debt financing to be converted into equity. Thereafter the investment would be exited as explained in the equity exit options stated above. The last resort for a debt investor would be forced seizure of assets as per the powers vested with the trustee, liquidation of the company or reference to the National Company Law Tribunal (NCLT) under the Insolvency and Bankruptcy Code (IBC) 2016 to force a sale of the company / assets to realise its dues. All these options require going through a judicial process and could be time-consuming. They also may not realise the dues to the AIF as per their book value. In such a case, the AIF incurs a loss and has to write-off the unrecoverable portion of its debt financing to the portfolio company.

12.5 Secondary Exits (Secondaries)

Secondary exit of investor interest would constitute sale of existing unit capital / partnership interests held by the investor to other co-investors in the fund or outside investors at an agreed value. This transaction is known as 'secondaries'. Secondaries are complex to execute from an AIF perspective since these are close ended and illiquid interests. Usually, if there are outstanding commitments of the exiting investor, these are transferred to the in-coming investor along with the existing unit capital.

Secondaries also need to address complexities in fund documentation. The terms of the contribution agreement need to be examined to ascertain the possibility; consents required from other co-investors or the manager and associated issues. The other complication that could arise is in the area of valuation of secondaries. Since fund interests are based on valuation of unrealised investments in underlying portfolio of illiquid investments, arriving at an agreed valuation is a complex exercise. Secondary transactions take place at a negotiated price, often at a substantial discount to net asset value (NAV). In the Indian context, secondaries are yet to evolve into an organised market in the AIF ecosystem.

12.6 Winding Up of an AIF

AIFs constituted as close ended funds are required to be dissolved at the end of the fund cycle or completion of the tenure of the scheme in order to make terminal distributions to the investors. Regulation 29 of the AIF Regulations provides that an AIF shall be wound up in accordance with the provisions of the statute under which it has been constituted under the following circumstances –

- when the tenure of the AIF or all schemes launched by the AIF, as mentioned in the PPM is over; or
- if it is the opinion of the trustees or the trustee company, as the case may be, that the AIF be wound up in the interests of investors in the units; or
- if 75% of the investors by value of their investment in the AIF pass a resolution at a meeting of unitholders that the AIF be wound up; or
- If SEBI so directs in the interests of investors.

Additionally, if an AIF is set-up as a company, it shall be wound-up in accordance with the provisions of the Companies Act, 2013. Similarly, if an AIF is set-up as a LLP, it shall be wound-up in accordance with the provisions of the Limited Liability Partnership Act, 2008. If an AIF is set-up as Body Corporate, it shall be wound-up in accordance with the provisions of the statute under which it was constituted. The trustees or the Board of Directors or designated partners of the AIF as the case maybe, shall intimate SEBI and the investors of the circumstances leading to the winding up of the AIF. On and from the date of such intimation, no further investments shall be made on behalf of the AIF.

The assets of the AIF, or its scheme, shall be liquidated within the 'Liquidation Period' and the proceeds shall be distributed to investors in the fund after satisfying all liabilities. 'Liquidation Period' is a period of 1 year following the expiry of tenure or extended tenure of the AIF scheme, for fully liquidating the asset of such existing AIF scheme. In case the AIF scheme is unable to liquidate some of its assets, in-specie distribution of such assets may be made to investors in the Fund as per the terms of the PPM document or Contribution Agreement or Subscription Agreement, subject to conditions as specified by SEBI.¹¹²

During liquidation period of a scheme, an AIF may distribute investments of their schemes, which are not sold due to lack of liquidity during the winding up process:

- a. In-specie to the investors; or
- b. Enter into 'Dissolution Period', after obtaining approval of at least 75 percent of the investors by value of their investment in the existing AIF scheme, and subject to conditions as specified by SEBI.¹¹³

A 'Dissolution Period' means the period following the expiry of the liquidation period of the scheme for the purpose of liquidating the unliquidated investments of the scheme of the AIF.

Prior to seeking approval from the investors, the AIF Manager shall disclose the following to the investors:¹¹⁴

¹¹²Inserted by SEBI (Alternative Investment Funds) (Second Amendment) Regulations, 2023 w.e.f. June 15, 2023.

¹¹³ Vide SEBI (AIF) (Second Amendment) Regulations, 2024 w.e.f. April 25, 2024.

¹¹⁴ SEBI Circular No.: SEBI/HO/AFD/PoD1/CIR/2024/026 dated April 26, 2024.

- a. The proposed tenure of the Dissolution Period, details of unliquidated investments, value recognition of the unliquidated investments for reporting to Performance Benchmarking Agencies etc.
- b. An indicative range of bid value along with the valuation of the unliquidated investments carried out by 2 independent valuers.

In the absence of consent from 75 percent of the investors for in-specie distribution, such AIF scheme shall liquidate its investments in a manner as specified by SEBI. Upon winding-up of the Fund, the Certificate of Registration shall be surrendered to SEBI.

12.7 Liquidation Scheme

Under the liquidation framework, an AIF may either launch a liquidation scheme or choose in-specie distribution of unliquidated investments.

12.7.1 Launch of Liquidation Scheme

Liquidation Scheme means a close-ended AIF scheme launched only for the purpose of liquidating the unliquidated investments in its existing AIF scheme, whose tenure has expired. The scheme launched by the AIF for this purpose shall contain the words 'Liquidation Scheme' in its name. The Liquidation Scheme shall file its PPM with SEBI through a merchant banker and the tenure of the scheme shall be determined at the time of such filing and the tenure so determined shall not be available for any extension. Liquidation schemes are not meant for any subscriptions by investors or for any investments by the AIF. Liquidation period for a liquidation scheme shall be a period of one year following the expiry of tenure or extended tenure of the scheme for fully liquidating the scheme of a close ended AIF. During the Liquidation Period, such close ended AIF or its scheme may sell its unsold/illiquid investments to the 'Liquidation Scheme' after obtaining approval of at least 75 percent of the investors by value of their investment in the existing AIF scheme (Original Scheme), and subject to conditions as specified by SEBI.

Upon receipt of units of the Liquidation Scheme, the Original Scheme shall mandatorily distribute units of Liquidation Scheme in-specie to its investors, in lieu of its own units issued at the time of its launch. The Liquidation Scheme shall be launched, and Original Scheme shall be wound up prior to the expiry of the Liquidation Period of the Original Scheme.

Upon receiving investor approval for making in-specie distribution to a Liquidation Scheme, the AIF shall arrange bids for a minimum of 25% of the value of the unliquidated investments.

- The bids shall be arranged for units representing consolidated value of each unliquidated investment of the Original Scheme's investment portfolio.

- The valuation of such unliquidated investments, done by two independent valuers, along-with the Bid Values for the same shall be disclosed to all investors in the Original Scheme.
- Dissenting investors of the Original Scheme, not in favour of selling the unliquidated investments, shall be offered an option to fully exit the Original Scheme out of the 25% bid arranged by the AIF or its Manager. After the dissenting investors exercise this exit option, any unsubscribed portion of the bid shall be used to provide pro-rata exit to non-dissenting investors.
- If the bidder or its related parties are investors in the Original Scheme, they shall not be provided exit from the Original Scheme out of the bid.¹¹⁵

Subsequently, the unliquidated investments of the Original Scheme shall be sold to the Liquidation Scheme and the Liquidation Scheme shall allot its units to the Original Scheme, at the following value:

- Bid value, if the AIF or its Manager arranges bid for a minimum of 25% of the value of unliquidated investments of the Original Scheme.
- One Rupee, if the AIF or its Manager fails to arrange bids for a minimum of 25% of the value of unliquidated investments of the Original Scheme.

Liquidation Schemes have been exempted from the requirement of obtaining SEBI's comments on the PPM. The Liquidation Schemes cannot accept any fresh commitment from any investor and cannot make any new investment. Tenure of Liquidation Schemes is calculated from the date of filing of PPM with SEBI and such tenure shall not be more than the tenure of the Original Scheme, excluding any permissible extension. A Liquidation Scheme cannot extend its tenure or sell its investments to another Liquidation Scheme and no 'Liquidation Period' shall be allowed to a Liquidation Scheme.

Performance of Liquidation Scheme shall also be reported to Performance Benchmarking Agencies. In order to capture the track record of the Investment Manager and to report to Performance Benchmarking Agencies, the Manager of an AIF scheme shall disclose to the investors, the valuation mechanism for any unliquidated investments sold to a Liquidation Scheme, at the time of seeking approval from its investors.

If an AIF scheme has invested in units of another AIF scheme and the investee AIF has launched a Liquidation Scheme, then such AIF scheme shall mandatorily make in-specie distribution of units, held by it, of the Liquidation Scheme, upon expiry of its tenure or extended tenure.

Illustration – An AIF Scheme 'Alpha' has invested in the units of another AIF Scheme 'Beta'. Beta has obtained requisite majority consent from its investors for launching a Liquidation

¹¹⁵'Related party' shall have same meaning as provided in SEBI (Listing Obligations and Disclosure Requirements) Regulations, 2015.

Scheme called 'Beta Liquidation Scheme'. Beta has distributed the units of Beta Liquidation Scheme to its investors including Alpha. In such a case, upon the expiry of its tenure or extended tenure as the case may be, Alpha shall mandatorily distribute the Beta Liquidation Scheme units held by it in specie to its own investors.

12.7.2 In-specie distribution of Unliquidated Investments

During the Liquidation Period, an AIF or its scheme may make in-specie distribution after obtaining approval of at least 75 percent of the investors by value of their investment in the existing AIF scheme (Original Scheme), and subject to conditions as specified by SEBI.

Upon receiving investor approval for making in-specie distribution of unliquidated investments, the AIF shall arrange bids for a minimum of 25% of the value of the unliquidated investments.

- The bids shall be arranged for units representing consolidated value of each unliquidated investment of the Original Scheme's investment portfolio.
- The valuation of such unliquidated investments, done by two independent valuers, along-with the Bid Values for the same shall be disclosed to all investors in the Original Scheme.
- Dissenting investors of the Original Scheme, not in favour of in-specie distribution, shall be offered an option to fully exit the Original Scheme out of the 25% bid arranged by the AIF or its Manager. After the dissenting investors exercise this exit option, any unsubscribed portion of the bid shall be used to provide pro-rata exit to non-dissenting investors.
- If the bidder or its related parties are investors in the Original Scheme, they shall not be provided exit from the Original Scheme out of the bid.

Subsequently, the unliquidated investments of the Original Scheme shall be distributed in-specie, at the following value:

- Bid value, if the AIF or its Manager arranges bid for a minimum of 25% of the value of unliquidated investments of the Original Scheme.
- One Rupee, if the AIF or its Manager fails to arrange bids for a minimum of 25% of the value of unliquidated investments of the Original Scheme.

The in-specie distribution shall be carried out and Original Scheme shall be wound up, prior to the expiry of the Liquidation Period of the Original Scheme. In order to capture the track record of the Investment Manager and to report to Performance Benchmarking Agencies, the Manager of an AIF scheme shall disclose to the investors, the value of the unliquidated investments distributed in-specie, at the time of seeking approval from its investors.

12.7.3 - Mandatory In-specie Distribution of Unliquidated Investments

If an AIF scheme fails to obtain the requisite investor consent, as mentioned above, for launching a Liquidation Scheme or making in-specie distribution of unliquidated investments, then the unliquidated investments shall be mandatorily distributed to investors in-specie, without obtaining consent from 75 percent of investors by value of their investment in the AIF. The in-specie distribution shall be made at One Rupee, for capturing in the track record of the manager and for reporting to Performance Benchmarking Agencies. In case any investor is not willing to accept the above valuation on in-specie distribution, the investment shall be written off by such investor.

Compliance Responsibility:

The Investment Manager, Trustee and key management personnel of an AIF shall be responsible for compliance with the procedure prescribed above. Upon making in-specie distributions in any manner mentioned above, Investment Manager of an AIF shall submit its report on compliance to SEBI on the SEBI Intermediaries Portal.

The Investment Manager of the AIF shall report the following to Performance Benchmarking Agencies, in a timely manner for the purpose of performance benchmarking:

- the value of sale of unliquidated investments to a Liquidation Scheme, or
- the value at which in-specie distribution of unliquidated investments was made.

The Investment Manager shall also make suitable disclosures with regard to the same in the PPMs of subsequent schemes.

Though the modalities for launching of Liquidation Schemes and for distributing the investments of AIFs in-specie are in place, SEBI has notified that no AIFs shall launch any new Liquidation Schemes post April 25, 2024.¹¹⁶

12.8 Dissolution Period

A 'Dissolution Period' means the period following the expiry of the liquidation period of the scheme for the purpose of liquidating the unliquidated investments of the scheme of the AIF. A scheme shall enter a dissolution period only after receiving requisite consent from the existing investors.

The scheme entering into a dissolution period shall file, through a merchant banker, an Information Memorandum along with a Due Diligence Certificate by a merchant banker with SEBI, before the expiry of the liquidation period or any extension of the liquidation period.

¹¹⁶ Vide SEBI (AIF) (Second Amendment) Regulations, 2024 w.e.f. April 25, 2024.

The dissolution period of a scheme of an AIF shall not be more than the original tenure of the scheme and shall not be extended in any manner upon expiry of the dissolution period. The scheme of the AIF shall not accept any fresh commitment from any investor and shall not make any new investments during the dissolution period.

Sample Questions: Chapter 12

1. Under the SEBI (AIF) Regulations 2012, annual reporting by a Category I AIF to investors shall be:

- a. towards the end of the fund tenure
- b. after the final close
- c. within 180 days from the close of the financial year**
- d. within 90 days after the balance sheet date

2. The fund has to maintain records relating to _____.

- a. all material contracts of investee companies
- b. valuation policies and practices**
- c. monetary policy prescribed by RBI
- d. effective rate of return

3. Fund activity reporting to SEBI under the AIF Regulations shall be on a _____.

- a. monthly basis
- b. annual basis
- c. quarterly basis**
- d. six-monthly basis

4. Any change in the board of directors of an investee company has to be reported by the manager to AIF investors under the reporting requirements. State whether True or False.

- a. True
- b. False**

5. Fund documents once signed cannot be amended during the life of the AIF vehicle. State whether True or False.

- a. True
- b. False**

Section D: Taxation and Regulatory Framework

Chapter 13: TAXATION

Learning Objectives:

After studying this chapter, you should know about:

- Various aspects related to AIF taxation
- Withholding of tax by an AIF and withholding of tax by the Indian portfolio companies
- Taxation for residents and non-residents in India
- Relevant indirect taxes (GST, Stamp Duty)
- Basics of GAAR and MLI

This Unit discusses broadly about the taxation framework applicable to AIF activity in India under the Income Tax Act, 1961 (hereinafter referred to as the ITA) and its subordinated legislation. Associated discussion on taxation of investors (resident and non-resident) are also provided as found applicable. However, the basic scheme of taxation under the ITA for the investors and computational requirements are not discussed in detail since they are outside the scope of this workbook.

13.1 Taxation of Category I and Category II AIFs

In respect of investors, the basis of charge under Income Tax Act, 1961 (hereinafter referred to as the ITA) depends upon the residential status of the taxpayer during a tax year, as well as the nature of the income earned. A person (natural or juridical) who is a resident in India is liable to taxation in India on worldwide income, subject to certain tax exemptions / deductions as may be applicable. A person who is treated as non-resident for Indian tax purposes is generally subject to tax in India only on such person's Indian-sourced income or income accrued, received or deemed to be accrued or received in India.

13.1.1 Taxation arising to the AIF under the ITA

AIFs can be in the form of a trust, a limited liability partnership (LLP), a company or a body corporate. Majority of the AIFs are constituted as a contributory, determinate, irrevocable trust under the Indian Trusts Act, 1882. AIFs are required to be registered with SEBI under the AIF Regulations (or migrated from the erstwhile Venture Capital Regulations).

The taxability of Category I and II AIFs is governed by Section 10(23FBA), 10(23FBB), 194LBB and 115UB (Chapter XII–FB - Special Provisions Relating to Tax on Income of Investment Funds and Income Received from such Funds) of the ITA.

The ITA has accorded tax pass through status to 'Investment Funds' with respect to income, other than business income from investments. The term 'Investment Fund' is defined under Section 115UB of the ITA as "any fund established or incorporated in India in the form of a trust or a company or a limited liability partnership or a body corporate which has been granted a certificate of registration as a Category I or a Category II Alternative Investment

Fund and is regulated under the SEBI (Alternative Investment Fund) Regulations, 2012, made under the Securities and Exchange Board of India Act, 1992 or regulated under the International Financial Services Centres Authority (Fund Management) Regulations, 2022 made under the International Financial Services Centres Authority Act, 2019 (50 of 2019)".¹¹⁷ Therefore, Category I and II AIFs would enjoy tax pass through status at fund level in case of income other than business income.

The concept of 'tax pass through' enables zero tax liability on the income (other than business income) at Investment Fund level. The income generated by the Investment Fund, other than business income, will be taxable in the hands of the beneficiaries (investors) directly as per their respective tax status.

As per section 115UB read with section 10(23FBA) of the ITA, any income (other than business income) earned by an Investment Fund is exempt in its hands and is chargeable to income tax directly in the hands of its investors in the same manner as if it were the income accruing or arising to, or received by, such investors had the investments been made directly by them. As far as business income is concerned, section 115UB read with section 10(23FBB) of the ITA states that such business income accruing or arising to or received by an Investment Fund is taxable at the fund level at: (a) the specified rate in Finance Act of the relevant year (where such fund is a company or firm); (b) the maximum marginal rate (MMR¹¹⁸) (in other cases); and is therefore exempt in the hands of the investors.

Also, as per section 115UB of the ITA, any business loss at the fund level is not allowed to be passed through to its investors but is permitted to be carried forward for set-off against income of subsequent year/(s) business income in accordance with the provisions of the ITA. Loss (other than business loss) shall be allowed to be passed through to the investors and allowed to be carried forward and set-off in the hands of the investors of the AIF where the investors have held the units of the AIF for at least 12 months.

Characterisation of income – Capital Gains vs Business income

A determination of whether the securities are held as capital assets or as stock-in-trade is a mixed question of law and fact and would depend on the facts and circumstances of each particular case, and upon whether the activities of the Fund could be regarded as amounting to the carrying on of a business or profession.

Some of the following principles have been laid down by various judicial precedents for characterisation of income from sale of securities as "business income" or "capital gains." These may be used as broad guidelines for determining the character of income. Any single factor in isolation cannot be conclusive in determining the exact nature of the transaction of

¹¹⁷ Updated by the Finance Act 2023 w.e.f. April 1, 2023.

¹¹⁸ MMR means "maximum marginal rate" means the rate of income-tax (including surcharge on income-tax, if any) applicable in relation to the highest slab of income in the case of an individual, association of persons or, as the case may be, body of individuals as specified in the Finance Act of the relevant year.

investment in securities. All factors and principles need to be construed harmoniously. The following principal guidelines characterise the income from sale of securities as business income or capital gains:

- Motive for the purchase of securities as perceived at the time of sale;
- The frequency of transactions and the period of holding of the securities;
- Treatment of the securities and profit or loss on their sale in the accounts of the assessee/ taxpayer;
- The source of funds out of which the securities were acquired - borrowed or owned;
- The existence of an object clause permitting trading in securities;
- Acquisition of the securities – from primary market or secondary market; and
- The infrastructure employed for share transactions.

To sum up, to arrive at the exact nature of the transaction, all the factors and principles stated above need to be considered in totality. Mere dependence on one test will not give a complete picture of the exact nature of the transaction of investment and no accurate conclusions can be arrived at in that case.

The Central Board of Direct Taxes (CBDT), apex administrative tax body in India, stated that in case of listed shares or other securities held for a period of more than 12 months, where the assessee/ taxpayer desires to treat the income arising from the transfer of such securities as capital gains, the same shall not be put to dispute by the Indian Revenue authorities.

Accordingly, in case the securities are generally held for a period of more than 12 months by the AIF, its resultant income should be treated as “capital gains.”

In the context of transfer of unlisted shares, the CBDT has issued a clarification stating that income arising from transfer of unlisted shares would be considered under the head “capital gains” irrespective of the period of holding with a view to avoid dispute/ litigation and to maintain uniform approach (with tax treatment on transfer of listed shares).¹¹⁹ However, the above shall not apply in the following cases:

- The genuineness of transactions in unlisted shares itself is questionable; or
- The transfer of unlisted shares is related to an issue pertaining to lifting of corporate veil; or
- The transfer of unlisted shares is made along with the control and management of underlying business and the Indian Revenue authorities would take appropriate view in such situations.

Further, CBDT has issued a clarification stating that the exception to transfer of unlisted shares made along with control and management of underlying business would not apply to Category I and II AIFs.

¹¹⁹ Vide Instruction No. F.No. 225/12/2016/ ITA.II dated 2 May 2016.

13.1.2 Taxation in the hands of resident investors

The ITA provides that income of an Investment Fund other than income characterised as “business income” should be exempt from tax, in the hands of the Investment Fund and should be chargeable to tax directly in the hands of the unitholders as under:

- a. The income shall be chargeable to tax in the hands of the Unitholders in the same manner as if it were the income accruing or arising to, or received by the Unitholder had the investments, made by the Fund been made directly by the Unitholder.
- b. The income paid to the Unitholders by the Fund or credited to the account of the Unitholders by the Fund, shall be deemed to be of the same nature and in the same proportion in the hands of the Unitholders, as it had been received by or as accrued / arisen to the Fund.
- c. The income accrued / arisen to or received by the Fund in any financial year (i.e. April to March) which has not been credited to the account of or distributed to the Unitholders shall be deemed to have been credited by the Fund to the account of the Unitholders at the end of that financial year. Such credit would be made in the same proportion as the Unitholders would have been entitled to receive the income had it been paid in that financial year.
- d. Once the income is included in the total income of the Unitholder in a previous year, on account of having been accrued or arisen in the said previous year, it shall not be included in the total income of such person in the previous year in which such sum is actually paid to the Unitholder by the Fund.
- e. If the net computation of total income at the Fund level is a loss (not being in the nature of business losses), then such loss should be passed through to its Unitholders for set-off or carry forward while computing their income. However, in order to be eligible for pass-through of losses, such Unitholders should continue to hold units in the Fund for a period of at least 12 months.

13.1.2.1 Overview of taxation of different streams of income in the hands of the Unitholders

The AIF generally earns income in the following nature from its portfolio investments (i.e. investments in debt securities/equity instruments etc.):

- Dividend income
- Interest income; and
- Exit gains arising in the form of sale or buy back or transfer of securities held in portfolio entities.

The tax implications in the hands of the unitholders (where income is not characterised as business income in the hands of the Investment Fund) are discussed in the subsequent paragraphs.

A. Interest income

Interest income shall be taxable under the head 'Income from Other Sources' at the tax rates (plus applicable surcharge and health and education cess) applicable to ordinary income of resident investors.

B. Dividend income

The Indian company declaring dividend are not required to pay any dividend distribution tax on dividend distributed/ paid/ declared to its shareholders. The dividend income is taxable in the hands of the shareholders at applicable rates (plus applicable surcharge and health and education cess).

Further, no deduction shall be allowed for expenses against such dividend income, other than deduction of interest expenditure under section 57 of the ITA which shall be capped at 20% of the dividend income.

Dividend income (net of deductions, if any) will be taxable at the tax rates (plus applicable surcharge and health and education cess) applicable to ordinary income of resident investors.

Further, as per section 80M of the ITA, any Indian company which receives dividend from another Indian company and the dividend is distributed by the first mentioned Indian company to its shareholders before the specified due date (i.e., one month prior to the date of filing tax return under section 139 of the ITA), then the first mentioned Indian company can claim a deduction of the dividend received by it from the other Indian company.

C. Capital gains

Gains will be taxable in the hands of the investor depending on the nature of securities.

i. Listed equity shares acquired and sold on a recognised stock exchange

If listed equity shares are held for a period of more than 12 months, then it is to be classified as long-term capital asset; in any other case, the assets are classified as short-term capital assets.

For long-term capital gains arising from the transfer of listed equity shares where Securities Transaction Tax (STT) has been paid on both acquisition and transfer, no tax is payable if the total long-term capital gains from such shares during the financial year do not exceed Rs. 1,25,000.¹²⁰

¹²⁰The limit is increased from Rs. 1 lakh to Rs. 1.25 lakh by the Finance (No. 2) Act, 2024 with effect from 23-07-2024. When calculating this threshold, the aggregate of long-term capital gains from transfers made anytime between 01-04-2024 and 31-03-2025 shall be considered.

If the long-term capital gain exceeds Rs. 1,25,000, the excess amount will be taxed as per Section 112A of the IT Act at a rate of 12.5% (plus applicable surcharge and health and education cess) without the benefit of indexation.¹²¹

The CBDT has issued a notification¹²² clarifying that condition of paying STT at time of acquisition shall not apply for all transactions of acquisition of equity shares other than the following negative list:

- where the acquisition of existing listed equity shares in a company whose equity shares are not frequently traded on a recognised stock exchange of India is made through a preferential issue, other than specified preferential issues;
- where transactions for acquisition of existing listed equity shares in a company is not entered through a recognised stock exchange, except in specified circumstances; and
- acquisition of equity shares during the period beginning from the date on which the company is delisted from a recognised stock exchange and ending on the date immediately preceding the date on which the company is again listed on a recognised stock exchange.

Short-term capital gains from sale of equity shares listed on a recognised stock exchange in India, on which STT is paid, are subject to tax at 20% (plus applicable surcharge and cess).¹²³

ii. Unlisted equity shares sold through an offer for sale in an IPO or after listing on recognised stock exchange

If the unlisted shares are sold through offer for sale in an IPO, then gain on such shares will be regarded as long-term capital gains, if they are held for more than 24 months or else it will be regarded as short-term capital gains.

If the unlisted shares are acquired and subsequently sold after listing of the shares on the recognised stock exchange, then the gains on such shares will be regarded as long-term capital gains if they were held for more than 12 months or else they will be regarded as short-term capital gains. Thus, such shares are considered as listed equity shares and follow the applicable taxation rules as discussed earlier.

For long-term capital gains arising from the transfer of equity shares where Securities Transaction Tax (STT) has been paid on both acquisition and transfer, no tax is payable if the total long-term capital gains from such shares during the financial year do not exceed Rs.

¹²¹ The Finance (No. 2) Act, 2024 has provided a uniform tax rate of 12.5% on long-term capital gain arising from transfer of any long-term capital asset on or after 23-07-2024. Where listed equity shares are transferred before 23-07-2024, the long-term capital gain shall be taxable at the rate of 10% (plus applicable surcharge and health and education cess).

¹²² Notification No. 60/2018, dated 01-10-2018

¹²³ The Finance (No. 2) Act, 2024 has increased the tax rate from 15% to 20% for listed equity shares transferred on or after 23-07-2024. Where the shares are transferred before 23-07-2024, the capital gain shall be taxable at the rate of 15%.

1,25,000. If the long-term capital gain exceeds Rs. 1,25,000, the excess amount will be taxed at a rate of 12.5% (plus applicable surcharge and health and education cess) without the benefit of indexation.

The CBDT vide Notification No. 60, dated 01-10-2018 has clarified that condition of paying STT at time of acquisition shall not apply for all transactions of acquisition of equity shares other than the prescribed negative list discussed earlier.

As the negative list does not cover acquisition of unlisted equity shares, the condition of payment of STT on acquisition should not be applicable. Hence, if such shares are offered for sale under an IPO or transferred after listing on recognised stock exchange, the long-term capital gains should be subject to tax under Section 112A of the IT Act at 12.50% (plus applicable surcharge and health and education cess) on sale of such equity shares.

Short-term capital gains from sale of equity shares, on which STT is paid, are subject to tax at 20% (plus applicable surcharge and health and education cess).

iii. Acquisition and sale of unlisted shares

If unlisted equity shares are held for a period of more than 24 months, then it is to be classified as long-term capital asset; in any other case, the assets are classified as short-term capital assets.

Long-term capital gains on transfer of unlisted shares are subject to tax at 12.5% (plus applicable surcharge and health and education cess) without indexation benefit.

Short-term capital gains on transfer of unlisted shares are liable to tax at the applicable tax rates for the respective slab of income (plus applicable surcharge and health and education cess) of Investors.

iv. Listed debentures

If the listed debentures are held for a period of more than 12 months, then they are to be classified as long-term capital assets; in any other case, such assets are classified as short-term capital assets.

Long-term capital gains on transfer of listed debentures are subject to tax at 12.5% (plus applicable surcharge and health and education cess) without considering indexation benefit.

As per the amendments in the Finance Act 2023, capital gains on redemption/ transfer of Market Linked Debentures shall be deemed to be capital gains arising from a short-term capital asset, irrespective of the period of holding.

Short-term capital gains on transfer of listed debentures are liable to tax at the applicable tax rates (plus applicable surcharge and health and education cess) of Investors.

v. Unlisted debentures

If the unlisted debentures are held for a period of more than 24 months, then they are to be classified as long-term capital assets; in any other case, such assets are classified as short-term capital assets.¹²⁴

As per the amendments in the Finance Act 2023, capital gains on redemption/ transfer of Market Linked Debentures shall be deemed to be capital gains arising from a short-term capital asset, irrespective of the period of holding.

Further, as per the amendments in the Finance Act, 2024, capital gains on redemption/ transfer of unlisted debentures on or after 23-07-2024 shall be deemed to be capital gains arising from a short-term capital asset, irrespective of the period of holding.¹²⁵

Short-term capital gains on transfer of unlisted debentures are liable to tax at the applicable tax rates (plus applicable surcharge and health and education cess) of investors.

vi. Buyback of shares by a company

Buyback on or before 30-09-2024

Income arising to a shareholder from the buyback of shares by a domestic company on or before 30-09-2024 is exempt under Section 10(34A). However, the domestic company is liable to pay a distribution tax at 20% (plus applicable surcharge and health and education cess) under Section 115QA on the difference between the consideration paid for the buyback and the amount received by the company at the time of issuing those shares determined as per Rule 40BB.

Where a foreign company pays consideration for buy back of shares, the shareholders are liable to pay tax on the capital gains arising from share so bought back by the company. The difference between the cost of acquisition of shares and the value of consideration received by the shareholder is deemed as capital gain under Section 46A.

Buyback on or after 01-10-2024

When the buyback takes place on or after 01-10-2024, the domestic company will no longer be required to pay distribution tax under Section 115QA. Instead, the income arising from the buyback to the shareholder will be taxable in his own hands.

vii. Conversion of preference shares into equity shares

As per the provisions of ITA, the conversion of preference shares of a company into equity shares of that company would not be regarded as a transfer. In such an event, no capital gains

¹²⁴ The Finance (No. 2) Act, 2024 has reduced the holding period from 36 months to 24 months with effect from 23rd July 2024. If unlisted debentures are transferred before 23-07-2024, they shall be treated as long-term capital asset if held for more than 36 months.

¹²⁵ Where unlisted debentures are transferred or redeemed before 23-07-2024, the long-term capital gains are subject to tax at 20% (plus applicable surcharge and health and education cess) without indexation benefits and the short-term capital gains are liable to tax at the applicable tax rates (plus applicable surcharge and health and education cess) of Investors.

would arise in the hands of the beneficiaries on conversion of preference shares of a company into equity shares. At the time of transfer of the converted equity shares, the cost of acquisition of a convertible preference shares would be deemed to be the cost of acquisition of such equity shares. Further, the holding period prior to conversion shall be included in the period of holding of the equity shares issued pursuant to conversion.

viii. Conversion of debentures into equity shares

The Fund could invest in debt securities/ debentures of Indian portfolio companies which may convert into shares of the company at a later date. Conversion of such debt securities/ debentures of a company into shares of that company is not regarded as a transfer under the provisions of the ITA. Hence, no capital gains would arise in the hands of the beneficiaries on conversion of convertible debentures of a company into equity shares. At the time of transfer of the converted equity shares, the cost of acquisition of a convertible debenture would be deemed to be the cost of acquisition of such equity shares. Further, the holding period prior to conversion shall be included in the period of holding of the equity shares issued pursuant to conversion.

ix. Share of profits from an LLP/ partnership firm

The share of a partner in the total income of an LLP/ partnership firm, would be exempt from tax in the hands of such partner, subject to satisfaction of conditions. Accordingly, such share of profits from an LLP/ partnership firm on a tax pass through basis should also be exempt from tax in the hands of the unitholders of the Fund.

x. Transfer of partnership interests in LLP/ partnership firm

Any profit arising on transfer of partnership interest in an LLP/ partnership firm by the Fund could be characterised as capital gains or business income in the hands of the partner, depending on the facts and circumstances of each case. Partnership interest in an LLP/ partnership firm shall be deemed to be a long-term capital asset in case such interest was held by the Fund for more than 24 months¹²⁶, immediately preceding the date of transfer of such partnership interest. In case such gains are characterised as capital gains, the long-term capital gains shall be taxable at a rate of 12.5% (plus applicable surcharge and health and education cess) without indexation benefit. Short-term capital gains are liable to tax at the applicable tax rates for the respective slab of income (plus applicable surcharge and health and education cess) of investors.

xi. Temporary Investments – Other income from mutual funds, fixed deposits etc.

The income in the nature of interest on fixed deposits would be subject to tax in the hands of resident unitholders at the tax rates (plus applicable surcharge and health and education cess) applicable to resident investors.

¹²⁶ The Finance (No. 2) Act, 2024 has reduced the holding period from 36 months to 24 months with effect from 23-07-2024. If interest in LLP/Firm is transferred before 23-07-2024, it shall be treated as long-term capital asset if held for more than 36 months.

Distribution from mutual fund other than units purchased in foreign currency would be subject to tax in the hands of resident investors at the tax rates (plus applicable surcharge and health and education cess) applicable to resident investors.

Gains arising on transfer of units of Mutual Fund should be subject to income tax based on investment of the fund in equity and equity-related instruments.

xii. Transfer of Units of the Fund

Gains on sale of Units of the Fund may be taxable directly in the hands of the investors. The Indian income tax implications shall depend on the characterisation of the gains as “capital gains” or “business income”.

If the gains are characterised as “capital gains”, the tax treatment shall be as follows:

- Units of AIF shall be considered as long-term capital assets if held for a period of more than 12 months¹²⁷ (if listed) or 24 months¹²⁸ (if unlisted). Long-term capital gains on transfer of units of such AIF are subject to tax at 12.5% (plus applicable surcharge and health and education cess) without indexation benefit.
- Units of AIF shall be considered as short-term capital assets if held for 12 months or less (if listed) or 24 months or less (if unlisted). Short-term capital gains on transfer of units of such AIF are liable to tax at the applicable tax rates for the respective slab of income (plus applicable surcharge and health and education cess) of Investors.

If the gains are characterised as ‘business income’, then the net income (after deduction of related expenses including cost of units) should be taxable at the rates applicable to the resident investor.

13.1.3 Taxability of income for non-resident investors

A non-resident investor would be subject to taxation in India only, if it derives (a) Indian-sourced income; or (b) if any income is received / deemed to be received in India; or (c) if any income has accrued / deemed to have accrued in India in terms of the provisions of the ITA.

13.1.3.1 Taxation in the hands of the non-resident unitholders – Income of the Fund other than ‘business income’

The above provisions apply both to resident and non-resident investors in the same manner. (Refer para 13.1.2 for detailed explanation)

¹²⁷ The Finance (No. 2) Act, 2024 has reduced the holding period from 36 months to 12 months with effect from 23-07-2024. If units of listed AIF are transferred before 23-07-2024, it shall be treated as long-term capital asset if held for more than 36 months.

¹²⁸ The Finance (No. 2) Act, 2024 has reduced the holding period from 36 months to 24 months with effect from 23-07-2024. If units of unlisted AIF are transferred before 23-07-2024, it shall be treated as long-term capital asset if held for more than 36 months.

13.1.3.2 Benefits of Double Taxation Avoidance Agreement (Treaty)

The taxation of non-resident investors is governed by the provisions of the ITA, read with the provisions of the Treaty between India and the country of residence of such non-resident investor. As per section 90(2) of the ITA, the provisions of the ITA would apply to the extent they are more beneficial than the provisions of the Treaty [subject to General Anti Avoidance Rule (GAAR) provisions and provision of Multilateral Instrument to implement Tax Treaty Related Measures to prevent Base Erosion and Profit Shifting (MLI)]. Accordingly, availability of Treaty benefits should be a relevant factor in determining the India tax consequences in respect of such income in the hands of the non-resident investors.

In order to claim Treaty benefits, the non-resident is required to obtain a Tax Residency Certificate (TRC) issued by the foreign tax authority. Further, the non-resident shall also be required to furnish such other information or document as may be prescribed. In this connection, the CBDT vide its notification dated 1 August 2013 has prescribed certain information in Form No. 10F to be produced along with the TRC, if the same does not form part of the TRC.

The taxability of such income of the non-resident investors, in the absence of Treaty benefits, would be as per the provisions of the ITA. Also, the taxability of the income of the non-resident investors, from a country with which India has no Treaty, would be as per the provisions of the ITA.

13.1.3.3 Taxability of various streams of income for non-resident investors under the provisions of ITA

Interest income

In case of non-resident unitholders, as per the provisions of the ITA, interest income shall be taxable under the head 'Income from Other Sources' on *net* basis, at the tax rates (plus applicable surcharge and health and education cess) applicable to ordinary income of non-resident investors. However, certain specified interest income of a non-resident or foreign company is chargeable to tax on a gross basis at the special rates.

Dividend income

The Indian company declaring dividend would not be required to pay any dividend distribution tax on dividend distributed/ paid/ declared to its shareholders. The dividend income would be taxable in the hands of the shareholders.

The dividend income of a non-resident investor is taxable on a gross basis under Section 115A, Section 115AB, Section 115AC and Section 115AD without allowing any deduction for any expenditure incurred to earn such income.

Capital gains

Gains will be taxable in the hands of the investor depending on the nature of securities.

If the gains are characterised as capital gains:

As per section 45 of the ITA, any profits or gains arising from the transfer of capital assets are chargeable to income tax under the head 'capital gains'. Section 48 of the ITA provides that income chargeable as capital gains would be computed as the difference between the full value of the consideration received or accrued on the transfer of the capital asset and the cost of acquisition¹²⁹ of such asset plus expenditure incurred wholly and exclusively in connection to such transfer. The capital gains would be classified as long term or short term, depending upon the period of holding of the assets and the same is tabulated below.

Type of instrument	Period of holding	Characterisation
Listed securities ¹³⁰ / unit of UTI/ Unit of equity-oriented Fund / Zero Coupon Bonds	More than 12 months	Long Term Capital Asset
	12 months or less	Short Term Capital Asset
Unlisted securities ¹³¹ (including those offered through offer for sale as part of an IPO)	More than 24 months	Long term capital asset
	24 months or less	Short term capital asset

It is to be noted that capital gain arising from the transfer of the following capital assets is deemed to be capital gain arising from the transfer of a short-term capital asset, irrespective of the holding period:

- (a) Market Linked Debentures (MLDs) transferred, redeemed or matured on or after 01-04-2023
- (b) Specified Mutual Funds (SMFs) acquired on or after 01-04-2023
- (c) Unlisted Bonds or Unlisted Debentures transferred, redeemed or matured on or after 23-07-2024

i. Listed equity shares acquired and sold on a recognised stock exchange

If listed equity shares are held for a period of more than 12 months, then it is to be classified as long-term capital asset; in any other case, the assets are classified as short-term capital asset.

¹²⁹The Finance (No. 2) Act, 2024 has provided that no indexation benefit shall be available in respect of the long-term capital assets transferred on or after 23-07-2024.

¹³⁰The Finance (No. 2) Act, 2024 has amended the definition of 'short-term capital asset' with effect from 23-07-2024 and consider all listed securities (including units) as short-term capital assets if they are held for 12 months or less. Before 23-07-2024, listed units (except units of UTI or equity-oriented fund) were considered short-term if held for 36 months or less.

¹³¹The Finance (No. 2) Act, 2024 has amended the definition of 'short-term capital asset' with effect from 23-07-2024 and consider all unlisted securities as short-term capital assets if they are held for 24 months or less. Before 23-07-2024, only unlisted shares were considered short-term if held for 24 months or less and other unlisted securities were considered short-term if held for 36 months or less.

For long-term capital gains arising from the transfer of listed equity shares where STT has been paid on both acquisition and transfer, no tax is payable if the total long-term capital gains from such shares during the financial year do not exceed Rs. 1,25,000. If the long-term capital gain exceeds Rs. 1,25,000, the excess amount will be taxed as per Section 112A at a rate of 12.5% (plus applicable surcharge and health and education cess) without the benefit of indexation.

The CBDT has issued a notification clarifying that condition of paying STT at time of acquisition shall not apply for all transactions of acquisition of equity shares other than the prescribed negative list discussed earlier.

Short-term capital gains from sale of equity shares listed on a recognised stock exchange in India, on which STT is paid, are subject to tax at 20% (plus applicable surcharge and health and education cess).

ii. Unlisted equity shares sold through an offer for sale in an IPO or after listing on recognised stock exchange

If the unlisted shares are sold through offer for sale in an IPO, then gain on such shares will be regarded as long-term capital gains if they were held for more than 24 months or else it will be regarded as short-term capital gains.

If the unlisted shares subsequently sold after listing on the recognised stock exchange, then the gains on such shares will be regarded as long-term capital gains if they were held for more than 12 months or else it will be regarded as short-term capital gains.

For long-term capital gains arising from the transfer of equity shares where Securities Transaction Tax (STT) has been paid on both acquisition and transfer, no tax is payable if the total long-term capital gains from such shares during the financial year do not exceed Rs. 1,25,000. If the long-term capital gain exceeds Rs. 1,25,000, the excess amount will be taxed at a rate of 12.5% (plus applicable surcharge and health and education cess) without the benefit of indexation.

The CBDT vide Notification No. 60, dated 01-10-2018 has clarified that condition of paying STT at time of acquisition shall not apply for all transactions of acquisition of equity shares other than the prescribed negative list discussed earlier.

As the negative list does not cover acquisition of unlisted equity shares, the condition of payment of STT on acquisition should not be applicable and hence if such shares are offered for sale under an IPO or transferred after listing on recognised stock exchange, the long-term capital gains should be subject to tax under Section 112A at 12.5% (plus applicable surcharge and health and education cess) on sale of such equity shares.

Short-term capital gains from sale of equity shares, on which STT is paid, are subject to tax at 20% (plus applicable surcharge and health and education cess).

iii. Acquisition and sale of unlisted shares

If the unlisted equity shares are held for a period of more than 24 months, then it is to be classified as long-term capital asset; in any other case, the assets are classified as short-term capital asset.

Long-term capital gains on transfer of unlisted shares are subject to tax at 12.5% (plus applicable surcharge and health and education cess) without considering forex or indexation benefit.

Short-term capital gains on transfer of unlisted shares are liable to tax at the rate of 30% in case of FPIs and at applicable tax rates in case of other investors (plus applicable surcharge and health and education cess).

iv. Listed debentures

If the listed debentures are held for a period of more than 12 months, then they are to be classified as long-term capital assets; in any other case, such assets are classified as short-term capital assets.

Long-term capital gains on transfer of listed debentures are subject to tax at 12.5% (plus applicable surcharge and health and education cess) without considering indexation benefit. In case of FPIs, foreign currency fluctuation shall also be not allowed while computing capital gain.

As per the amendments in the Finance Act 2023, capital gains on redemption/ transfer of Market Linked Debentures shall be deemed to be capital gains arising from a short-term capital asset, irrespective of the period of holding.

Short-term capital gains on transfer of listed debentures are liable to tax at the rate of 30% in case of FPIs and at applicable tax rates in case of other investors (plus applicable surcharge and health and education cess).

v. Unlisted debentures

If the unlisted debentures are held for a period of more than 24 months¹³², then they are to be classified as long-term capital assets; in any other case, such assets are classified as short-term capital assets.

As per the amendments in the Finance Act 2023, capital gains on redemption/ transfer of Market Linked Debentures shall be deemed to be capital gains arising from a short-term capital asset, irrespective of the period of holding.

¹³² The Finance (No. 2) Act, 2024 has reduced the holding period from 36 months to 24 months with effect from 23rd July 2024. Thus, if unlisted debentures are transferred before 23-07-2024, they shall be treated as long-term capital asset if held for more than 36 months.

Further, as per the amendments in the Finance Act, 2024, capital gains on redemption/ transfer of unlisted debentures on or after 23-07-2024 shall be deemed to be capital gains arising from a short-term capital asset, irrespective of the period of holding.¹³³

Short-term capital gains on transfer of unlisted debentures are liable to tax at the rate of 30% in case of FPIs and at applicable tax rates in case of other investors (plus applicable surcharge and health and education cess).

vi. Buyback of shares by a company

Buyback on or before 30-09-2024

Income arising to a shareholder from the buyback of shares by a domestic company on or before 30-09-2024 is exempt under Section 10(34A). However, the domestic company is liable to pay a distribution tax at 20% (plus applicable surcharge and health and education cess) under Section 115QA on the difference between the consideration paid for the buyback and the amount received by the company at the time of issuing those shares determined as per Rule 40BB.

Buyback on or after 01-10-2024

When the buyback takes place on or after 01-10-2024, the domestic company will no longer be required to pay distribution tax under Section 115QA. Instead, the income arising from the buyback to the shareholder will be taxable in his own hands.

vii. Conversion of preference shares into equity shares

As per the provisions of ITA, the conversion of preference shares of a company into equity shares of that company would not be regarded as a transfer. In such an event, no capital gains would arise in the hands of the beneficiaries on conversion of preference shares of a company into equity shares. At the time of transfer of the converted equity shares, the cost of acquisition of a convertible preference shares would be deemed to be the cost of acquisition of such equity shares. Further, the holding period prior to conversion shall be included in the period of holding of the equity shares issued pursuant to conversion.

viii. Conversion of debentures into equity shares

The Fund would invest in debt securities/ debentures of Indian portfolio companies which may convert into shares of the company at a later date. Conversion of such debt securities/ debentures of a company into shares of that company is not regarded as a transfer under the ITA. Hence, no capital gains would arise in the hands of the beneficiaries on conversion of convertible debentures of a company into equity shares. At the time of transfer of the converted equity shares, the cost of acquisition of a convertible debenture would be deemed to be the cost of acquisition of such equity shares. Further, the holding period prior to

¹³³ Where unlisted debentures are transferred or redeemed before 23-07-2024, the long-term capital gains are subject to tax at 10% (plus applicable surcharge and health and education cess) without forex and indexation benefits and the short-term capital gains are liable to tax at the rate of 30% in case of FPIs and at applicable tax rates in case of other investors (plus applicable surcharge and health and education cess).

conversion shall be included in the period of holding of the equity shares issued pursuant to conversion.

ix. Share of profits from an LLP/ partnership firm

The share of a partner in the total income of an LLP/ partnership firm, would be exempt from tax in the hands of such partner, subject to satisfaction of conditions. Accordingly, such share of profits from an LLP/ partnership firm on a tax pass through basis should also be exempt from tax in the hands of the unitholders of the Fund.

x. Transfer of partnership interests in LLP/ partnership firm

Any profit arising on transfer of partnership interest in an LLP/ partnership firm by the Fund could be characterised as capital gains or business income in the hands of the partner, depending on facts and circumstances of each case. Partnership interest in an LLP/ partnership firm shall be deemed to be a long-term capital asset in case such interest was held by the Fund for more than 24 months¹³⁴, immediately preceding the date of transfer of such partnership interest. In case such gains are characterised as capital gains, the long-term capital gains shall be taxable at a rate of 12.5% (plus applicable surcharge and health and education cess) without indexation benefit. Short-term capital gains are liable to tax at the applicable tax rates for the respective slab of income (plus applicable surcharge and health and education cess) of investors.

xi. Temporary Investments – Other income from mutual funds, fixed deposits etc.

The income in the nature of interest on fixed deposits would be subject to tax in the hands of resident unitholders at the tax rates (plus applicable surcharge and health and education cess) applicable to resident investors.

Distribution from mutual fund would be taxable on a gross basis under Section 115A, Section 115AB, or Section 115AD without allowing any deduction for any expenditure.

xii. Transfer of Units of the Fund

Gains arising on transfer of units of the Fund from one beneficiary to another should be subject to income tax. Depending on facts of the case of each unitholder, the gains can be characterised as 'capital gains' or 'business income'. If the gains are characterised as "capital gains", the tax treatment shall be as follows:

¹³⁴ The Finance (No. 2) Act, 2024 has reduced the holding period from 36 months to 24 months with effect from 23-07-2024. If interest in LLP/Firm is transferred before 23-07-2024, it shall be treated as long-term capital asset if held for more than 36 months.

- Units of AIF shall be considered as long-term capital assets if held for a period of more than 12 months¹³⁵ (if listed) or 24 months¹³⁶ (if unlisted). Long-term capital gains on transfer of units of such AIF are subject to tax at 12.5% (plus applicable surcharge and health and education cess) without indexation benefit.
- Units of AIF shall be considered as short-term capital assets if held for 12 months or less (if listed) or 24 months or less (if unlisted). Short-term capital gains on transfer of units of such mutual fund are liable to tax at the rate of 30% in case of FPIs and at applicable tax rates in case of other investors (plus applicable surcharge and health and education cess).

If the gains are characterised as ‘business income’, then the net income (after deduction of related expenses including cost of units) should be taxable at the normal rates applicable to the non-resident investor.

13.1.3 Other relevant provisions of the ITA

Deemed sale consideration on sale of unquoted shares

As per section 50CA of ITA, if there is a transfer of unquoted shares of a company at a value lesser than the FMV, then the fair market value would be deemed to be the full value of sale consideration for computing the capital gains for such unquoted shares.

The rules for determining the FMV of shares have been prescribed under the IT Rules. As per the IT Rules, the FMV of unlisted equity shares would be based on the book values of assets and liabilities (to be calculated in the manner prescribed), whereas the FMV of all other shares and securities (other than equity shares) would be based on the market value of such shares and securities as certified by a Merchant Banker or a Chartered Accountant.

The taxability of such gains would be as discussed above.

Deemed income on shares/ securities received without consideration or for inadequate consideration

Section 56(2)(x) of the ITA provides that if a person receives any property (which includes securities such as equity shares, debentures, preference shares, etc.) at a price which is lower than its fair market value, then the difference between the fair market value and actual consideration (if greater than INR 50,000) shall be taxable in the hands of the recipient of such property. Accordingly, such other income would be chargeable to tax at the applicable tax rates for the respective slab of income (plus applicable surcharge and health and education cess) of Investors.

¹³⁵ The Finance (No. 2) Act, 2024 has reduced the holding period from 36 months to 12 months with effect from 23-07-2024. If units of listed AIF are transferred before 23-07-2024, it shall be treated as long-term capital asset if held for more than 36 months.

¹³⁶ The Finance (No. 2) Act, 2024 has reduced the holding period from 36 months to 24 months with effect from 23-07-2024. If units of unlisted AIF are transferred before 23-07-2024, it shall be treated as long-term capital asset if held for more than 36 months.

Bonus stripping

Any person who buys or acquires any units of a mutual fund or the Unit Trust of India within a period of three months prior to the record date (i.e., the date that may be fixed by a Mutual Fund or the Administrator of the specified undertaking or the specified company, for the purposes of entitlement of the holder of the units to receive additional unit without any consideration) and such person is allotted additional units (without any payment) on the basis of holding of the aforesaid units on the record date, and if such person sells or transfers all or any of the original units within a period of nine months after the record date while continuing to hold all or any of the additional units, then any loss arising to him on account of such purchase and sale of all or any of the units would be ignored for the purpose of computing his income chargeable to tax. Further, the loss so ignored would be deemed to be the cost of acquisition of such additional units as are held by him on the date of sale or transfer of original units.

Effective 1 April 2022, the bonus stripping provisions cover all securities and units (including units of a business trust, i.e., units of a REIT/ InvIT and beneficial interest of an investor in an AIF registered with SEBI).

Expenditure incurred in relation to income not includible in the total income

If any income of the Investor does not form part of the total income or is exempt under the provisions of the ITA then any expenditure incurred by the Investor, directly or indirectly, in relation to such income will not be allowed as deduction for the purpose of calculating the total taxable income of the Investor. For example, if the investor receives any income from buy back of its shares by the Indian company, any expense incurred in connection to earning the income shall not be allowed as a deduction.

Further, this section shall always apply in a case where exempt income has not accrued or arisen or has not been received during the previous year relevant to an assessment year and the expenditure has been incurred during the said previous year in relation to such exempt income.

Minimum Alternate Tax (MAT) / Alternate Minimum Tax (AMT)

The ITA provides for levy of MAT on corporates and AMT on non-corporates. If MAT/ AMT is held to be applicable to the unitholders, then income receivable by such unitholders from their investment in the Fund, should also be included to determine the MAT/ AMT.

The ITA provides for levy of MAT on domestic companies, if the tax amount calculated at the rate of 15% (plus surcharge and health and education cess) of the book profits, is higher than the tax amount calculated under the normal provisions of the ITA except in case of life insurance companies and certain other companies who have exercised option referred to in section 115BAA or section 115BAB of ITA.

In case where the domestic company opts to be taxed as per the rates and manner prescribed under Section 115BAA and 115BAB of the ITA, then MAT provisions shall not be applicable to

such domestic companies. Also, MAT credit (if any) shall not be allowed to be carried forward once the company exercises the option to avail reduced tax rates as mentioned above.

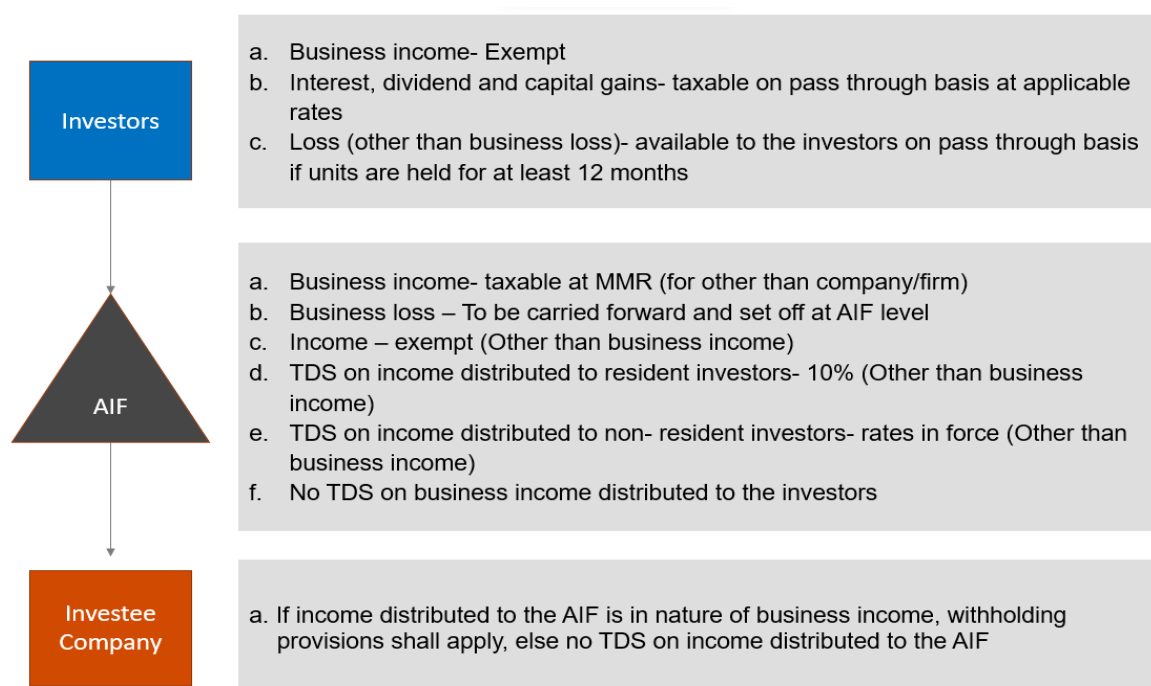
In case of non-corporate assessee, AMT is taxable at the rate of 18.5% (15% in case of co-operative society) (plus applicable surcharge and health and education cess) except in cases where option referred to in section 115BAC or section 115BAD or Section 115BAE of the ITA are exercised, subject to certain exceptions, on the adjusted total income if the tax amount so calculated under AMT is higher than the tax amount calculated under the normal provisions of the ITA.

The MAT/ AMT credit is available to be carry forward for a period of 15 years.

The MAT provisions shall not apply to foreign companies if,

- the assessee is a resident of a country with which India has a Treaty and the assessee does not have a PE in India; or
- the assessee is a resident of a country with which India does not have a Treaty and is not required to seek registration under the Indian corporate law.

The basic taxability of the Category I and Category II AIF and the investors may be graphically depicted as under:



13.1.4 Withholding of tax by an AIF

As per section 194LBB of the ITA, an Investment Fund is required to withhold tax on income distributed to its investors. The tax shall be deducted at the following rates:

- (a) In case of resident investor, the tax shall be deducted at the rate of 10% on all income (other than business income);
- (b) In case of non-resident investor, tax shall be deducted at the rate of 20% if income distributed is in nature of dividend. In respect of other income, the tax shall be deductible at the rates in force [as specified in the Finance Act of the relevant year or rates specified in the applicable Double Tax Avoidance Agreement (DTAA) entered into between India and the country of residence of such non-resident investor]. Investors are entitled to claim credit of taxes so withheld by the Investment Fund in their respective returns of income which are to be filed under the ITA.

13.1.5 Withholding of tax by the Indian portfolio companies

As per section 197A(1F) of the ITA and the notification issued by the CBDT¹³⁷, the payer of the income to an Investment Fund is not required to withhold any taxes while paying or crediting income (other than business income) to such Investment Fund. Therefore, the investment fund would not suffer any withholding of taxes from its non-business income.

13.1.6 Reporting compliances to be undertaken by the AIF under the ITA

It is mandatory for the Investment Fund to file its return of income as per the provisions of the ITA.

Further, the provisions of the ITA prescribe that the statement of income paid or credited by an Investment Fund to its unit holder in a given financial year shall be furnished by the person responsible for crediting or making payment of the income on behalf of an Investment Fund and the Investment Fund to the unit holder by 30th day of June of the following financial year. The prescribed form provided for this purpose is Form No. 64C, which is to be duly verified by the person paying or crediting the income on behalf of the Investment Fund in the manner indicated therein.

Similar statement is also to be furnished electronically by the Investment Fund in Form No. 64D to the jurisdictional Principal Commissioner of the Income tax or the Commissioner of Income tax by 15th day of June of the following financial year, under digital signature, duly verified by a practicing Chartered Accountant.

¹³⁷Notification No. 51/2015/SO 1703(E), dated 25-6-2015.

13.2 Set off and carry forward of loss under the ITA

Intra Head adjustment of loss (section 70 of the ITA)

If in any year the taxpayer (including AIFs) has incurred loss from any source, under a particular head of income, then such person is allowed to adjust such loss against income from any other source falling under the same head of income, subject to the following restrictions:

Long-term capital loss cannot be set off against any income other than income from long-term capital gains. However, short-term capital loss can be set off against long-term or short-term capital gains.

Speculative business losses cannot be set off against non-speculative business gains.

Inter Head adjustment of loss (section 71 of ITA)

If in any year, the taxpayer (including AIFs) has incurred loss under one head of income and is having income under other head of income, then such person can adjust the loss from one head against income from other head of income subject to the following restrictions:

- Before making inter-head adjustment, the taxpayer must first make intra-head adjustment.
- Loss under the head “Capital gains” cannot be set off against income under any other heads of income.
- Loss from business and profession cannot be set off against income chargeable to tax under the head “Salaries”.

Provisions under the Income-tax law in relation to carry forward and set off of capital loss (section 74 of the ITA)

If loss under the head “Capital gains” incurred during a year cannot be adjusted in the same year, then unadjusted capital loss can be carried forward to the next year.

In the subsequent year(s), such loss can be adjusted only against income chargeable to tax under the head “Capital gains”, however, long-term capital loss can be adjusted only against long-term capital gains. Short-term capital loss can be adjusted against long-term capital gains as well as short-term capital gains. Such loss can be carried forward for eight years immediately succeeding the year in which the loss is incurred.

13.3 GAAR

Under the ITA, the provisions of General Anti-Avoidance Rules (GAAR) are effective from 1 April 2017. The Indian Revenue authorities may invoke GAAR if arrangements are found to be impermissible avoidance arrangements. A transaction can be declared as an impermissible

avoidance arrangement, if the main purpose of the arrangement is to obtain a tax benefit and which satisfies one of the four tainted elements as follows:

- The arrangement creates rights or obligations which are ordinarily not created between parties dealing at arm's-length;
- It results in direct/ indirect misuse or abuse of the ITA;
- It lacks commercial substance or is deemed to lack commercial substance in whole or in part; or
- It is entered into or carried out in a manner, which is not normally employed for bona fide purposes.

In such cases, the tax authorities are empowered to reallocate the income from such arrangement, or re-characterise or disregard the arrangement. Some of the illustrative powers are:

- Disregarding or combining or re-characterising any step of the arrangement or party to the arrangement;
- Ignoring the arrangement for the purpose of taxation law;
- Relocating place of residence of a party, or location of a transaction or situs of an asset to a place other than provided in the arrangement;
- Looking through the arrangement by disregarding any corporate structure;
- Reallocating and re-characterising equity into debt, capital into revenue, etc.
- Disregarding or treating any accommodating party and other party as one and the same person;
- Deeming persons who are connected to each other parties to be considered as one and the same person for the purposes of determining tax treatment of any amount.

The above terms should be read in the context of the definitions provided under the ITA. The GAAR provisions shall be applied in accordance with such guidelines and subject to such conditions and manner as may be prescribed.

On 27 January 2017, the CBDT had issued clarifications on implementation of GAAR provisions in response to various queries received from the stakeholders and industry associations. Some of the important clarifications issued are as under:

- Where tax avoidance is sufficiently addressed by the Limitation of Benefit Clause ("LOB") in a Tax Treaty, GAAR shall not be invoked.
- GAAR shall not be invoked merely on the ground that the entity is located in a tax efficient jurisdiction.
- GAAR is with respect to an arrangement or part of the arrangement and limit of INR 30 million cannot be read in respect of a single taxpayer only.

13.4 MLI

Under a mandate given by G20 nations to tackle global tax avoidance, in 2015 the Organisation for Economic Co-operation and Development developed 15 Action Plans aimed at tackling Base Erosion and Profit Shifting strategies. Action Plan 15 of the BEPS project envisaged an innovative approach in the form of executing a Multilateral Instrument (MLI) for modifying the global Tax Treaty network in a timely and synchronised manner.

On 7 June 2017, India joined 66 other countries to sign the MLI proposing to modify its existing 93 comprehensive tax treaties. The Union Cabinet of India issued a press release dated 12 June 2019 approving the ratification of the MLI to implement Tax Treaty related measures to prevent BEPS. The application of MLI to a Tax Treaty is dependent on ratification as well as positions adopted by both the countries signing a Tax Treaty.

On June 25, 2019, India has taken the final step for implementation of MLI by depositing its instrument of ratification with the OECD. The effect of such ratification by India can be known only after MLI positions of respective Tax Treaty partners are known. On 9 August 2019, India has notified the provisions of Multilateral Convention under section 90(1) of the ITA and has specified the date of entry into force as 1 October 2019.

In order to prevent the granting of Tax Treaty benefits in inappropriate circumstances and to align it with the Multilateral Convention to implement Tax Treaty related measures to prevent Base Erosion and Profit Shifting, section 90(1) of the ITA provides that the Central Government shall enter into agreement(s) for the avoidance of double taxation without creating opportunities for non-taxation or reduced taxation through tax evasion or avoidance (including through Tax Treaty shopping arrangements aimed at obtaining reliefs provided in the said agreement for the indirect benefit to residents of any other country or territory).

Once MLI evolves in future, one would need to analyse its impact at that point in time on the existing tax treaties that India has entered into with other countries.

13.5 Other applicable taxes

13.5.1 Goods and Service Tax (GST)

GST will be applicable on services provided by the Investment Manager and Trustee to the Fund. GST at the rate of 18% would be levied on fees if any, payable towards investment management fee and Trusteeship Fees payable by the Fund to the Investment Manager and Trustee, respectively.

13.5.2 Stamp Duty

With effect from 1 July 2020, the issue, transfer, and sale of units of an AIF will be subject to stamp duty at the following rates:

Particulars	Stamp duty amount
Issue of units of AIF	0.005%
Transfer of units of AIF	0.015%

The same has to be paid by the Fund on behalf of the investors at the time of issuance of the units or transfer of the same. There is no stamp duty required at the time of redemptions.

13.6 Examples

Example 13.1: Withholding Taxes

Fund WT, a category II AIF was launched in the April 2022, as an Irrevocable, Determinate Trust with all resident investors. The primary aim of Fund WT was to make equity investments and debt investments:

Particulars	Amount
Committed Capital	INR 60,00,00,000
No. of units issued	6,00,000
NAV (INR)	1,000

The following table provides details of income and expenses for Fund WT, during the years.

Particulars	F.Y. 2022-2023	F.Y. 2023-2024	F.Y. 2024-2025
Dividend Income	3,50,00,000	3,80,00,000	3,95,00,000
Interest Income	1,95,00,000	1,95,00,000	1,95,00,000
Management Fees	1,53,80,000	1,59,35,000	1,65,20,000
Fixed Yearly Expenses	25,00,000	25,00,000	25,00,000

- i. Distribution of interest income from debentures is made on a yearly basis to the investors.
- ii. The NAV of the fund, at the end of financial year 2024-2025 is INR1195.00 and investors redeem all the units, as on March 31, 2025.
- iii. Compute the tax deducted by Fund WT along with the distributions made in all three financial years.

Solution:

Any distribution of income made by a Category II AIF, other than distribution of income in the nature of 'Profits or Gains from Business or Profession' is subject to withholding tax requirements, under section 194LBB of the ITA. Fund WT is liable to deduct TDS at the rate of 10%, at the time of credit of such income to the account of the investor, or at the time of payment, whichever is earlier.

Year wise computation of tax withholding on distributions made to investors:

Particulars	F.Y. 2022-2023	F.Y. 2023-2024	F.Y. 2024-2025
Distributions:			
Interest Income, on yearly basis	1,95,00,000	1,95,00,000	1,95,00,000
Distributions to investors at redemption (6,00,000 units @ INR 1,195)	-	-	71,70,00,000
Yearly Gross Distributions	1,95,00,000	1,95,00,000	73,65,00,000
Less: Withholding Tax @ 10% on interest income being distributed	19,50,000	19,50,000	19,50,000
Less: Withholding Tax @ 10% on Dividend Income	35,00,000	38,00,000	39,50,000
Yearly Net Distributions	1,40,50,000	1,37,50,000	73,06,00,000

Notes:

- As per section 194LBB of the ITA, an Investment Fund is required to withhold tax at the rate of 10% on all income (other than business income) payable to resident investors at the time of credit or payment, whichever is earlier. Therefore, Fund WT has a liability to withhold tax, at the time of crediting income to the account of investors. Thus, withholding at the rate of 10% on interest is undertaken by the Fund prior to payment of interest income.
- As per section 115UB (6) of the ITA the income accrued / arisen to or received by the Fund in any financial year (i.e. April to March) which has not been credited to the account of or distributed to the Unitholders shall be deemed to have been credited by the Fund to the account of the Unitholders at the end of that financial year. Such credit would be made in the same proportion as the Unitholders would have been entitled to receive the income had it been paid in that financial year. Therefore, Fund WT will

deduct tax on dividend income @ 10% on a yearly basis even if distribution is not made.

- Since the income is fully taxable on pass through basis in the hands of investors, no further tax should be payable by investors nor any tax should be deductible by the Fund on redemption of units.

Example 13.2: Total Income of Category II AIF and its unit holders

The following are the particulars of income of below four investment funds for F.Y.2024-25:

Particulars	ABC	PQR	XYZ	LMN
Business income (net of expenses)	50,00,000	NIL	- 50,00,000	NIL
Capital Gains income	NIL	30,00,000	NIL	-40,00,000
Income from other sources	30,00,000	80,00,000	90,00,000	30,00,000

Compute the total income of the investment funds and each unitholder for A.Y.2025-26, assuming that:

- (1) each investment fund has 20 unitholders each having one unit held by them for a period exceeding 12 months; and
- (2) income from investment in the investment fund is the only income of the unitholder.

Solution:

Computation of total income of the investment fund for A.Y. 2025-26

Particulars	ABC	PQR	XYZ	LMN
Business income	50,00,000	NIL	NIL	NIL
Total income	50,00,000	NIL	NIL	NIL

Notes:

The total income of Investment Fund ABC would be chargeable to tax @30% if the fund is set-up as a firm and @30%/25%/22%, as the case may, if the fund is set up as a company and at MMR, in any other case. Since most of the Funds are set-up in the form of a Trust, MMR shall apply.

In case of Investment Fund XYZ, the business loss of INR 50,00,000 is set-off against income from other sources of INR 90,00,000. Net income of INR 40,00,000 shall be taxable at applicable rates in the hands of unit holders.

Computation of total income of a unit holder for A.Y. 2025-26

Particulars	ABC	PQR	XYZ	LMN*
Capital Gains income	NIL	1,50,000	NIL	Carried forward to subsequent years for set-off (200,000)
Income from other sources	1,50,000	4,00,000	2,00,000	1,50,000
Total income	1,50,000	5,50,000	2,00,000	1,50,000

*Loss of INR 40,00,000 (INR 2,00,000 each) under the head “Capital gains” cannot be set-off against income under any other head. The same can be carried forward by the Unitholder for set-off in the subsequent years since, the units are held for a period of 12 months or more.

Sample Questions: Chapter 13

1. Which of the following Trust structures are eligible to pass-through income in the nature of 'Capital Gains', to its investors?
 - a. **Determinate Irrevocable Trust**
 - b. Determinate Revocable Trust
 - c. Indeterminate Irrevocable Trust
 - d. Indeterminate Revocable Trust

2. Which of the following is an example of capital gains for an AIF?
 - a. An investee company sells one of its business divisions at a huge profit
 - b. The founders of an investee company sell their shares to third parties at a profit.
 - c. An investee company makes an IPO at a huge valuation in which the founder sell their stock through an offer for sale.
 - d. **The AIF exits an investee company at a huge gain after 4 years of holding.**

3. Withholding tax means _____.
 - a. **a sum deducted from any income paid/ credited**
 - b. the tax on income not disclosed
 - c. additional tax and penalty for withholding information
 - d. tax that is withheld and carried forward to next year

4. In the case of a non-resident investor in an AIF, the allowability of withholding tax paid in India in their home country tax assessment is subject to the provisions of the DTAA between India and their home country. State whether True or False.
 - a. **True**
 - b. False

5. Since start-ups generally issue their shares to AIFs at a huge valuation, the chances of accruing capital gains to the AIF in such investments is negligible. State whether True or False.
 - a. **True**
 - b. False

CHAPTER 14: REGULATORY FRAMEWORK

LEARNING OBJECTIVES:

After studying this chapter, you should know about:

- SEBI (AIF) Regulations, 2012
- SEBI (PIT) Regulations, 2015
- SEBI (PFUTP) Regulations, 2003
- Prevention of Money Laundering Act, 2002
- Foreign Exchange and Management Act, 1999
- SEBI (ICDR) Regulations, 2018
- Various reporting requirements under SEBI, FATCA and CRS

A. SEBI (Alternative Investment Funds) Regulations, 2012

Securities and Exchange Board of India (SEBI) is a statutory regulatory body entrusted with the responsibility to regulate the Indian Capital Markets. It monitors and regulates the securities market and protects the interests of the investors by enforcing certain rules and regulations and promoting the development of the securities market in India.

SEBI has introduced the SEBI (Alternative Investment Funds) Regulations in 2012 to regulate pooled investment funds in India, such as venture capital funds, angel funds, private equity funds, infrastructure funds, debt funds, social venture funds and hedge funds. If any Fund or person managing such Fund fails to comply with the regulations, such person will be liable to pay a minimum penalty of INR 1 lakh. Such penalty may extend up to INR 1 lakh for each day of non-compliance with regulations, subject to a maximum of INR 1 crore or three times the amount of gains made out of such non-compliance, whichever is higher.¹³⁸

14.1 Registration Process and Eligibility Criteria

14.1.1 Registration Requirements

On and from the commencement of these Regulations, all existing and proposed AIFs that are domiciled in India by virtue of being incorporated in India are subject to compulsory registration with SEBI. Existing schemes will be allowed to complete their agreed tenure, however, such funds shall not raise any fresh monies other than commitments already made till registration is granted. The funds registered as venture capital fund under SEBI (Venture Capital Funds) Regulations, 1996 shall continue to be regulated by the said regulations till the existing fund or scheme managed by the fund is wound up. Such funds may seek re-

¹³⁸ Vide section 15EA of SEBI Act

registration under SEBI (AIF) Regulations subject to approval of two-thirds of their investors by value of their investment.

As per SEBI (Alternative Investment Funds) Regulations, an AIF can seek registration in one of the following Categories:

1. **Category I Alternative Investment Fund** – Such type of funds invests in start-ups, early-stage ventures, social ventures, SMEs, infrastructure or other sectors, areas which the government and regulators consider as socially or economically desirable. Examples of Category I AIFs are:
 - Venture Capital Funds
 - Social Impact Funds
 - SME Funds
 - Infrastructure Funds
 - Special Situation Funds
 - Corporate Debt Market Development Fund
2. **Category II Alternative Investment Fund** – Such type of funds is prohibited from taking leverage or borrowing, except as prescribed by SEBI. Such Funds do not fall in either Category I or Category III of AIFs. Examples of Category II AIFs are:
 - Private Equity Funds
 - Debt Funds
3. **Category III Alternative Investment Fund** – Such type of funds uses diverse or complex trading strategies. They may also employ leverage, including through investment in both listed and unlisted derivatives, to make short-term profits. Funds such as Hedge Funds, or funds which trade with a view to make short term returns, fall under Category III AIFs.
4. **Specified Alternative Investment Fund** -- SEBI may specify regulations for such type of funds that do not fall under any 3 categories mentioned above.

The permissible legal structures of an AIF seeking registration under the SEBI (Alternative Investment Funds) Regulations, are as under:

- A “Company” formed under the Companies Act, 2013
- A “Trust” formed under a Trust Deed, duly registered under the provisions of the Registration Act, 1908
- A “Limited Liability Partnership” incorporated under a Partnership Deed, which is filed with Registrar under the provisions of the Limited Liability Partnership Act, 2008

- A “Body Corporate” established under the laws of the Central or State Legislature

14.1.2 Registration Criteria and Documentation

SEBI decides on the eligibility and registration of an AIF by examination of the given documents and criteria for eligibility. These are listed below.

1. The Memorandum of Association in case of a company (registered under the Companies Act or any Central / State Act); or the Trust Deed in case of a Trust (registered under the Indian Trusts Act, 1882 and the Registration Act, 1908); or the Partnership deed in case of a limited liability partnership (registered under the Limited Liability Partnership Act, 2008) permits it to carry on the activity of an AIF. Registration of these Legal Documents is compulsory for every applicant. SEBI may stipulate additional information requirements and filing of other documents in individual cases.
2. AIFs are prohibited from making an invitation to the public to subscribe to its units. Accordingly, such prohibition should be included in the memorandum and articles of association / or trust deed / or partnership deed of the applicant.
3. The Applicant, including its Sponsor and Manager, should be “fit and proper” as defined in Schedule II of SEBI (Intermediaries) Regulations, 2008, which specifies the following criteria:
 - (i) integrity, reputation and character
 - (ii) no history of restraint orders and convictions
 - (iii) financial competence based on net worth and solvency
 - (iv) no history of being a willful defaulter
4. The key investment team of the Manager of Alternative Investment Fund shall fulfil the following criteria:¹³⁹
 - (a) At least one key personnel shall have the relevant certification as specified by SEBI. In case of expiry of the validity of such certification, the personnel shall obtain fresh certification to ensure compliance with certification norms.¹⁴⁰
 - (b) at least one key personnel with professional qualification in finance, accountancy, business management, commerce, economics, capital market or banking from a university or an institution recognised by the Central or any State Government or a foreign university or a CFA charter from CFA Institute

¹³⁹Vide SEBI (AIF) (Amendment) Regulations, 2020 w.e.f. October 19, 2020.

¹⁴⁰Vide SEBI (AIF) (Second Amendment) Regulations, 2023, w.e.f. from May 10, 2024. The requisite certification notified by SEBI is NISM-Series-XIX-C: Alternative Investment Fund Managers Certification Examination.

or any other qualification as may be specified by SEBI; provided that both the requirements, as stated in 4(a) and 4(b), may be fulfilled by the same key personnel;¹⁴¹

5. The Manager or Sponsor has the necessary infrastructure and manpower to effectively discharge its activities;
6. The applicant has clearly described at the time of registration the investment objective, the targeted investors, proposed corpus, investment style or strategy and proposed tenure of the fund or scheme;
7. Whether the applicant or any entity established by the Sponsor or Manager has earlier been refused registration by SEBI.

14.1.3 Disclosure Requirements

The applicant of AIF shall submit all necessary information to SEBI which is helpful for granting the Registration Certificate. Sponsor or Manager of the Fund shall appoint a Custodian registered with SEBI, for safekeeping of securities/goods of the AIF and provide details to SEBI, at the time of Registration.

An AIF must submit the following disclosures to SEBI, in prescribed format at the time of seeking Registration Certificate.

Disclosure	Particulars
General Information	○ Contact Details of Registered Office and Principal Place of Business ○ Direct Contact numbers and Email-id of Contact Person ○ Legal Structure of Applicant – Body Corporate or LLP or Trust or Company with Date and Place of Incorporation ○ Category under which Registration is being sought ○ Fund Structure – As open-ended or closed-ended ○ Fund Infrastructure – To conduct Alternative Investment activities ○ Placement Memorandum draft copy ○ Details of any previous registration with SEBI or RBI or any other regulatory authority
Applicant Details: If Fund formed as a Trust	○ Details of Trust activities ○ Details of Eligibility for Registration: ▪ Whether the Trust Deed is registered under the Registration Act, 1908 ▪ Whether the Trust Deed permits activities of an AIF

¹⁴¹ Vide SEBI (AIF) (Amendment) Regulations, 2020 w.e.f. October 19, 2020.

Disclosure	Particulars
	▪ Whether the applicant is prohibited from making an invitation to the public to subscribe to its units ○ Details of Trustees and Trustee Company: ▪ Contact Details of Registered Office of Trustee Company or Individual ▪ Direct Contact numbers and Email-id of Contact Person of Trustee ▪ Identity and Address proof of Trustees/Directors of Trustee Company ▪ Details of any previous registration with SEBI or RBI or any other regulatory authority ▪ Brief write up on the activities of the Trustee Company/ Profile of Trustees
Applicant Details: If Fund formed as a Company or Body Corporate	○ Details of Company activities ○ Shareholding pattern and profile of the directors ○ In case of a Body Corporate, whether the applicant is set up or established under the laws of the Central or State Legislature ○ Details of Eligibility for Registration: ▪ Whether the Memorandum of Association permits activities of an AIF ▪ Whether the applicant is prohibited by its memorandum and articles of association from making an invitation to the public to subscribe to its units
Applicant Details: If Fund formed as a Limited Liability Partnership (LLP)	○ Details of LLP activities ○ Beneficial ownership pattern and profile of the partners ○ Details of Eligibility for Registration: ▪ Whether the Partnership Deed is duly filed under the provisions of the Limited Liability Partnership Act, 2008 and it permits activities of an AIF ▪ Whether the applicant is prohibited by its partnership deed from making an invitation to the public to subscribe to its units
Sponsor Details	○ Contact Details of Registered Office and Principal Place of Business of Sponsor ○ Direct Contact numbers and Email-id of Contact Person, on behalf of Sponsor ○ Legal Structure of Sponsor – Individual/Partnership/Company/Body Corporate and Date of Incorporation of the entity ○ For Individual Sponsor Entity – Details of Professional Qualification and a Brief Profile

Disclosure	Particulars
	○ For Non-Individual Sponsor Entity – Details of shareholding pattern/ Partnership interests and profile of the directors/partners including their professional qualification ○ Identity and Address proof of Sponsor/Directors of Sponsor/Partners of Sponsor ○ Details of past registration of the Sponsor with SEBI ○ Details of past experience of the Sponsor in managing capital pools or fund management or asset management or investment advisory or dealing in securities market and financial assets. ○ Copies of the financial statements for the previous financial year ○ Details of any Alternative Investment Fund or Venture Capital Fund floated by the Sponsor previously, and registered with SEBI
Investment Manager Details	○ Contact Details of Registered Office and Principal Place of Business of Investment Manager ○ Direct Contact numbers and Email-id of Contact Person, on behalf of Investment Manager ○ Legal Structure of Investment Manager – Individual / Partnership / Company / Body Corporate and Date of Incorporation of the entity ○ For Individual Investment Manager Entity – Details of Professional Qualification and a Brief Profile ○ For Non-Individual Investment Manager Entity – Details of shareholding pattern/ Partnership interests and profile of the directors/partners including their professional qualification ○ Identity and Address proof of Investment Manager /Directors of Investment Manager /Partners of Investment Manager ○ Details of past registration of the Investment Manager with SEBI ○ Details of past experience of the Investment Manager in managing capital pools or fund management or asset management or investment advisory or dealing in securities market and financial assets. ○ Copies of the financial statements for the previous financial year ○ Details of any Alternative Investment Fund or Venture Capital Fund which was managed/advised by the Investment Manager previously, and registered with SEBI
Business Plan and Investment Strategy	○ Investment objective and investment style/strategy of the fund. ○ Target investors ○ Target sectors ○ Proposed corpus ○ Proposed fees to the Sponsor and Manager ○ Tenure of the fund or scheme

Disclosure	Particulars
	○ Details of proposed use of leverage, if applicable
Details of Regulatory Action taken in the past	○ Details of any litigation in securities market and any order passed against Applicant, Sponsor or Investment Manager for violation of securities laws. ○ Details of any litigation in securities market having an adverse effect on applicant's business and any order passed against Applicant, Sponsor or Investment Manager for violation of securities laws. ○ If the Applicant/Sponsor/Trustee/Investment Manager have been previously refused a Registration Certificate by SEBI or have got their Registration suspended, details of the same.
Declaration	Declaration from the Applicant, Sponsor and Manager stating that: ○ They are "fit and proper" persons ○ They will contribute the required committed capital to fulfil the Sponsor Contribution in the AIF i.e. they will contribute 2.5 percent of the corpus of the Fund or INR 5 crore, whichever is lower, in case of a Category I or II AIF. ○ They will comply with the General Investment Conditions and Restrictions applicable to the AIF.

In addition to the above information submitted by the Applicant, SEBI may ask the Applicant to submit any further information or clarification, as deemed fit, to consider the Application for granting Registration Certificate.

14.1.4 Conditions for Registration

1. The AIF shall abide by the provisions of the Act and the SEBI (Alternative Investment Funds) Regulations, 2012;
2. The AIF shall not carry on any other activity other than permitted activities;
3. The AIF shall forthwith inform SEBI in writing, if any information or particulars previously submitted to SEBI are found to be false or misleading in any material particular or if there is any material change in the information already submitted.
4. An Alternative Investment Fund which has been granted registration under a particular category cannot change its category subsequent to registration, except with the approval of SEBI.

14.1.5 In-Principle Approval for an AIF

Filing of a Trust Deed and getting it registered under the Registration Act, 1908 with a Registration Certificate, may be time-consuming. Similarly, registering a Partnership Deed of an LLP, with a Registration Certificate, under the Limited Liability Partnership Act, 2008 may also be time-consuming. In order to speed-up the Registration of Applicants under the SEBI (Alternative Investment Funds) Regulations, SEBI may grant an “in-principle” approval to eligible applicants.

If SEBI is satisfied that the applicant meets the eligibility criteria stated in the SEBI (Alternative Investment Funds) Regulations, it may grant an in-principle approval to the applicant for the AIF, even if the Trust Deed or Partnership Deed, as applicable, is not registered under the applicable law.

However, after receiving the in-principle approval:

- The applicant must ensure the Trust Deed or Partnership Deed, as applicable, is registered under the applicable law, within 6 months from the date of in-principle approval from SEBI.
- The applicant may start accepting commitments from its investors, but shall not call/accept money from such investors, until receipt of Registration Certificate from SEBI.

14.2 Sponsor / Manager Commitment

1. The Manager or Sponsor shall have a continuing interest in Category I and II AIFs (in each scheme where there are multiple schemes in the fund) of not less than 2.5% of the corpus or INR 5 crore whichever is lower.
2. The commitment shall be in the form of investment in the scheme of the fund and shall not be through the waiver of management fees.
3. The contribution of each employee or director of the fund or employee or director of the investment manager in the corpus shall not be less than INR 25 lakh if they choose to participate as investors in the fund in individual capacity.
4. The Manager or Sponsor shall disclose their investment interest in the AIF to the investors.

14.3 Concept of Open-ended and Close-ended Funds

In an open-ended fund structure:

- Investors contribute their capital upon admission or subscription to the Fund.

- Investors may make additional capital contributions from time-to-time, if required.
- Redemption of capital from the fund is permitted at pre-defined regular intervals, being quarterly, half-yearly or yearly.

In a close-ended fund structure:

- Investors make capital commitments, which are called by the Investment Manager by making “Capital Calls” from investors, over a pre-defined period known as “Commitment Period”.
- The Commitment Period is usually the first three years of the Fund Tenure.
- Redemption of capital is not permitted in a close-ended fund structure, prior to winding-up of the Fund. Investors would need to pay an exit load for exiting from the fund, after the lock-in period specified in the PPM.

14.3.1 Category I and II AIFs: Close-ended only

Category I and II AIFs need to compulsorily be formed as close-ended funds because such investments are primarily illiquid. Illiquidity refers to the inability of the fund to sell its investments reasonably at proper exit valuations within the life cycle of the fund. In the case of AIF investments, illiquidity can be especially severe when a fund has remaining capital calls or when an investor attempts to liquidate a position before its termination. Investors are meant to realise cash returns on their fund interests only when realisation events occur through the sale of the underlying portfolio companies.

14.3.2 Listing of Close-ended Funds/ Schemes

Units of a scheme launched by a close-ended AIF are eligible for listing on a recognized stock exchange. The scheme should have a minimum tradable lot of INR 1 crore and listing shall be permitted only after final close of the fund or scheme. Units of angel funds shall not be listed on any recognised stock exchange. Listing of close-ended funds/schemes on a recognized stock exchange is voluntary.

In order to get listed on a recognized stock exchange:

- I. An AIF must make an application to a recognized stock exchange for listing of units of its close-ended scheme on the stock exchange platform, submit the required documentation and pay the designated fees based on the size of the Fund/Scheme.

- II. Based on the documentation, the recognized stock exchange grants an in-principle approval for listing of scheme units on the exchange platform.
- III. The AIF seeks approval from SEBI, for listing of units of its close-ended scheme on the Stock Exchange platform.
- IV. After receiving SEBI approval for listing of units, the recognized stock exchange can grant the final approval and list the units of the close-ended scheme for trading purpose.

Benefits of Listing of AIF units:

- I. Provide investors with an easy exit opportunity, subject to KYC.
- II. Enable price discovery in a demand-supply mechanism.
- III. Enable investors to view the NAV of the fund on a timely basis.
- IV. Ensure liquidity in the AIF industry.

14.4 Accredited Investor Framework

SEBI introduced the framework for Accredited Investors (AIs) in the Indian securities markets. As per the framework, the AIs may avail (a) flexibility in minimum investment amount and (b) concessions from specific regulatory requirements applicable to investment products, subject to specific conditions.

14.4.1 Accredited Investors

Accredited Investors means any person who is granted a certificate of accreditation by an accreditation agency, based on the following eligibility criteria:

A. Individual, Hindu Undivided Family (“HUF), Family Trust, Sole Proprietorship or Partnership:

- Eligibility Criteria for accreditation is as follows:
 - annual income should be at least INR 2 crores; or
 - net worth should be at least INR 7.5 crore, out of which not less than INR 3.75 crores should be in the form of financial assets; or
 - annual income should be at least INR 1 crore and minimum net worth to be INR 5 crore, out of which not less than INR 2.5 crore should be in the form of financial assets,
- In case of accreditation of Individual investors, HUFs and sole proprietorships, the value of the primary residence of the Individual, Karta of the HUF, or the Sole Proprietor, as the case may be, shall not be considered for calculation of net worth.

- In case of joint investors in a fund, the following additional conditions shall apply:
 - If joint holders are parent(s) and child(ren), at least one person should independently fulfil the eligibility criteria for accreditation.
 - If joint holders are spouses, their combined income/net worth should fulfil the eligibility criteria for accreditation.
- In case of a partnership firm set up under the Indian Partnership Act, 1932, each partner should independently meet the eligibility criteria for accreditation.

B. Body Corporates and Trusts:

- In case of a body corporate, net worth is at least INR 50 crore.
 - $\text{Net Worth} = (\text{Capital} + \text{Free Reserves}) - (\text{Accumulated Losses} + \text{Deferred Expenditure not written-off})$
- In case of a trust, other than a family trust, net worth is at least INR 50 crore.
 - $\text{Net Worth} = (\text{Book Value of all Assets, other than intangible assets}) - (\text{Book Value of total liabilities})$
- For Body Corporates and Trusts, the eligibility criteria shall be considered on the following basis:
 - Financial information as per the statutory audit; or
 - Financial information as per audit by a statutory auditor, as on a date during the financial year in which the application is made for accreditation

In case of foreign investors seeking accreditation, the eligibility should be determined based on the rupee equivalent of their income and/or net worth, as applicable. Foreign Investors which are incorporated or established in any other entity structure other than as Individuals, HUFs, Family Trusts, Sole Proprietorships, Partnership Firms or Trusts, they shall be subject to eligibility criteria as applicable to Body Corporates.

The following institutions are deemed to be an accredited investor and may not be required to obtain a certificate of accreditation:

- Central Government and the State Governments
- Developmental agencies set up under the aegis of the Central Government or the State Governments
- Funds set up by the Central Government or the State Governments
- Qualified institutional buyers as defined under SEBI (Issue of Capital and Disclosure Requirements) Regulations, 2018
- Category I foreign portfolio investors
- Sovereign wealth funds and multilateral agencies
- Any other entity as may be specified by SEBI from time to time

14.4.2 Accreditation Agency

‘Accreditation Agency’ means a subsidiary of a recognized stock exchange or a subsidiary of a depository or any other entity as may be specified by SEBI. Investors desirous of being reckoned as Accredited Investors need to submit an application to the Accreditation Agency. The applicants should be “fit and proper” to participate in the securities market and not be wilful defaulters or have convictions or restraint orders against them.

Accreditation Agencies or KYC Registration Agencies (KRAs) can access Know Your Customer (KYC) documents of applicants available with them in capacity of KRA, or access the same from the database of other KRAs, for the purpose of accreditation.

The Agency should issue an “Accreditation Certificate” to eligible accredited investors, bearing a unique accreditation number, name of the Accreditation Agency, PAN of the applicant and validity of the accreditation with a start date and an end date. Accreditation shall be granted solely based on the KYC and the financial information of the applicants. Accreditation Certificate shall include the following disclaimer:

“The assessment of the applicant for accreditation is solely based on the applicant’s KYC and financial information and does not in any manner exempt market intermediaries and pooled investment vehicles from carrying out necessary due diligence of the accredited investors at the time of on boarding them as their clients.”

The accreditation shall be valid for a period of 2 years, from the date of such accreditation, if the applicant meets all eligibility criteria for the preceding one year. If the applicant consistently meets the eligibility criteria in each of the two preceding financial years, the accreditation shall be valid for a period of 3 years, from the date of such accreditation. If the applicant is a newly incorporated entity, which does not have financial information for the preceding financial year but meets the applicable net-worth criteria as on the date of application, the accreditation certificate issued shall be valid for two years from the date of such accreditation.

The Accreditation Agencies are responsible for:

- Verification of documents submitted by the applicants
- Timely processing of applications for accreditation and issuance of Accreditation Certificate
- Maintaining data of accredited investors
- Verification of accreditation status
- Maintaining confidentiality of investor information
- Any other responsibilities as may be specified by SEBI

14.4.3 Large value fund for Accredited Investors

“Large value fund for accredited investors” means an AIF or scheme of an AIF in which each investor (other than the Manager, Sponsor, employees or directors of the Fund or employees or directors of the Manager) is an accredited investor and invests not less than seventy crore rupees.

Procedure for Accredited Investors to avail benefits linked to Accreditation

- Accredited Investors may avail flexibility in the minimum investment amount or concessions from specific regulatory requirements, applicable as per the SEBI (AIF) Regulations, by submitting a copy of their Accreditation Certificate and an undertaking to the fund, to the effect that:
 - The Accredited Investor wishes to avail the benefits under the AI framework and provides “Consent”
 - The Accredited Investor has the ability to bear the financial risks associated with the investment
 - The Accredited Investor has the necessary knowledge and means to understand the features of the units offered by AIFs and the risks associated with it
 - The Accredited Investor is aware that the units offered by AIFs is meant for Accredited Investors and may not be subject to the same regulatory oversight as other investment products and funds meant for other non-accredited investors
- An AIF is responsible to independently verify the status of accreditation of a prospective investor, from the concerned Accreditation Agency. AIFs may obtain further additional undertakings from the prospective investors, so as to not dilute or contravene the undertakings as mentioned above.
- Prior to entering into any agreement, an AIF must disclose to the Accredited Investors details of regulatory concessions available for the proposed investment, and the relevant conditions applicable under the AI framework. Upon entering into a client agreement, the AIF must provide the following information:
 - The details of regulatory concessions agreed upon, between the AIF and the Accredited Investor, along-with conditions for availing the same.
 - The consequences in the event of the investor becoming ineligible to be an Accredited Investor, during the tenure of the agreement.

Withdrawal of Consent given by Accredited Investors to discontinue the benefits linked to Accreditation:

The client agreement entered into by an AIF shall provide the modalities for withdrawal of Consent by Accredited Investors and the consequences for the same.

- Accredited Investors shall have the flexibility to withdraw their Consent and discontinue availing benefits of accreditation, subject to the following:
 - The Accredited Investors, who withdraw the Consent after availing the benefit of lower ticket size of investment, shall be responsible to increase their minimum investment amount as stipulated under the SEBI (Alternative Investment Funds) Regulations, within the time frame mentioned in the client agreement.
 - In case an Accredited Investor withdraws the Consent after availing regulatory concessions but before the expiry of the client agreement, the investments made by such investor shall be “grandfathered” i.e. the investments shall continue to be treated as investments made by an accredited investor. With effect from the date of withdrawal of consent, all further transactions shall be in accordance with the SEBI (Alternative Investment Funds) Regulations.
- The Accredited Investors investing in “Large Value Fund for Accredited Investors” or any Category I AIF/Category II AIF/launched exclusively for the accredited investors, in which regulatory concessions have been availed, shall not have the facility to withdraw the Consent.

14.5 First Close, Final Close and Tenure of Funds / Schemes

14.5.1 First Close and Final Close

First Close is important for the Investment Manager to check the suitability of the Fund for the target investors and their response to the stated investment strategy. The sooner an AIF Manager achieves the target of first close, the better chances the Manager has to raise the full target of capital commitments for the Fund/Scheme launched.

At the date of declaration of First Close, the corpus of any AIF shall not be less than the minimum corpus of INR 20 crore, as prescribed by SEBI (Alternative Investment Funds) Regulations. Sponsor commitment in the AIF, at the date of declaration of First Close shall not be reduced, withdrawn or transferred, after declaration of First Close.

Existing AIFs whose PPMs were taken on record by SEBI prior to 12 months from November 17, 2022, and have not declared their First Close, shall submit an updated PPM with SEBI through a registered Merchant Banker along with due diligence certificate. Further, the updated PPM shall be circulated to the investors before declaration of First Close. It is further

clarified that if the First Close of an AIF scheme is not declared within the timeline prescribed above, the AIF shall file a fresh application for launch of its schemes as per applicable provisions of SEBI (Alternative Investment Funds) Regulations by paying requisite fee to SEBI.

For Large Value Funds (LVFs), the First Close must be declared within 12 months from the date of grant of registration of the AIF or date of filing of PPM of scheme with SEBI, whichever is later.

The First Close is followed by a Final Close, and the period for final close is usually defined in the PPM which could be lower or higher than 1 year. Final close marks the end of the fund-raising process for the AIF/Scheme. The investors who want to allocate funds to this AIF scheme have access to more information, as compared to investors in the first close, as they can analyse the performance of the scheme during the period between first close and final close. A close-ended AIF cannot accept more investors after the final close of the fund.

Existing AIF schemes which have declared their First Close before November 17, 2022, may continue to calculate their tenure from the date of Final Close. Such existing schemes, which are yet to declare Final Close, shall declare their Final Close as per the timeline provided in their respective PPMs and the fund shall not have any discretion to extend the said timeline provided in the PPM.

14.5.2 Tenure of a Fund/ Scheme

The tenure of Category I and II AIFs (if there is only one scheme under it) or each scheme therein shall be determined at the time of application to SEBI, subject to a minimum tenure of 3 years. SEBI has clarified that the tenure shall be computed from the date of declaration of first close of the scheme, and the first close must be achieved within twelve months from the date of SEBI communication to take the PPM document of the AIF on record. The trust or incorporated entity may have a different term as per its incorporation documents but each scheme of the AIF (in Category I and II) needs to be close ended for a defined term. Extension of the tenure of the close ended Category I and II AIFs may be permitted up to 2 years, subject to approval of two-thirds of the unit holders by value of their investment in the AIF. In the absence of consent of unit holders, the AIF shall fully liquidate within one year following expiration of the fund tenure or extended tenure.

An AIF may modify the tenure of a scheme at any time before declaration of its First Close. Prior to declaration of the First Close, the investor may withdraw or reduce commitment provided to the AIF scheme.

14.6 Investors' subscription to the Fund/Scheme

Minimum investment by an investor in an AIF shall be INR 1 crore.¹⁴² In case investors are employees/directors of the AIF or employees/directors of the Investment Manager of AIF, the minimum amount of investment from such investors shall be INR 25 lakh. In case of investors investing in a Social Impact Fund, which invests only in securities of not-for-profit organizations registered or listed on a social stock exchange, the minimum value of investment by an individual investor shall be INR 2 lakh.

14.7 Dematerialization of AIF Units:

AIFs must issue units in dematerialise form, subject to conditions specified by SEBI,¹⁴³ and as per the implementation standards formulated by the pilot SFA (Standard Setting Forum for AIFs), in consultation with SEBI, inter-alia including formats for information, records to be maintained by AIF managers, with respect to investor-wise holding / transactions in the Aggregate Escrow Demat Account, and reporting of the same to Depositories and Custodians.¹⁴⁴

As per the implementation standards by SFA, units already issued by AIF schemes, to existing investors who have not provided their demat account details, shall be credited to a separate demat account named "Aggregate Escrow Demat Account". This account shall be opened by AIFs for the sole purpose of holding demat units on behalf of such investors. In case new units are to be issued in demat form to such investors, the same shall be allotted to them and credited to the Aggregate Escrow Demat Account. As and when investors of the AIF provide their demat account details, units held in the Aggregate Escrow Demat Account shall be transferred to the respective investors' demat accounts within 5 working days. No other transfer of units from/within the Aggregate Escrow Demat Account is permissible.

AIF Schemes with corpus $\geq$ Rs. 500 Crore have created International Securities Identification Numbers (ISINs) for their units issued and commenced crediting units of the schemes to investors' demat accounts. In case some investors have not provided their demat account details, the investment manager shall adhere to the implementation standards by SFA and ensure that units of all investors have been credited to their respective demat accounts

¹⁴² Not applicable to Accredited Investors, as per SEBI (Alternative Investment Funds) (Third Amendment) Regulations, 2021

¹⁴³ SEBI Circular No.: SEBI/HO/AFD/PoD1/CIR/2023/96 dated June 21, 2023 on Issuance of units of AIFs in dematerialised form.

¹⁴⁴ SEBI Circular No.: SEBI/HO/AFD/PoD1/CIR/2023/183 dated December 11, 2023 on Credit of units of AIFs in dematerialised form.

before January 31, 2024. AIF units held in the Aggregate Escrow Demat Account can be redeemed and its proceeds shall be distributed to respective investors' bank accounts, with full audit trail of the same.

Summary of Timelines: For Credit of Units of AIFs, in demat accounts of respective investors	Schemes with corpus $\geq$ INR 500 crore as on October 31, 2023	Schemes with corpus $<$ INR 500 crore as on October 31, 2023 and schemes launched after October 31, 2023 irrespective of corpus
Investors who have provided their demat account details	Units issued after October 31, 2023, shall be in demat form and credited only to investors demat accounts.	Units issued after April 30, 2024, shall be in demat form and credited only to investors demat accounts.
Investors who have not provided their demat account details	For investors on-boarded prior to November 01, 2023, units shall be credited in Aggregate Escrow Demat Account temporarily, till investors provide their demat account details.	For investors on-boarded prior to May 01, 2024, units shall be credited in Aggregate Escrow Demat Account temporarily, till investors provide their demat account details.
Completion of credit of demat units to a) demat accounts of investors who have provided demat account details and b) Aggregate Escrow Demat Account, for those who have not provided demat account details	Latest by January 31, 2024	Latest by May 10, 2024

14.8 Raising Corpus Capital

1. The fund shall not solicit or collect funds for corpus creation except by way of private placement of units (partnership interests in the case of an LLP and equity shares or other securities in the case of a company).
2. The AIF may raise funds from any investor whether Indian, foreign or non-resident Indians by way of issue of units, subject to the provisions of the FEMA, 1999.

3. Social impact funds can issue “social units”, which means units issued to investors who have agreed to receive only social returns or benefits and no financial returns against their contribution.
4. Each scheme of the AIF shall have a corpus of at least INR 20 crore. However, the scheme of the social impact fund shall have a corpus of at least INR 5 crore.
5. An AIF can accept the following investors as joint investors:
 - an investor and his/her spouse
 - an investor and his/her parent
 - an investor and his/her daughter/son
 and not more than 2 persons shall act as joint investors. In case of any other investors acting as joint investors, for every investor, the minimum investment amount of INR 1 crore 145 shall apply.¹⁴⁶
6. No scheme of the AIF shall have more than 1000 investors. In the case of a company, this limit is regulated by the Companies Act, 2013 which currently stipulates not more than 200 investors in a private placement.
7. The Investment Manager or the Sponsor of every AIF shall have sufficient skin-in-the-game and a continuing interest.

An AIF shall share losses in the fund with all investors based on their pro-rata holding in the fund. No scheme of the AIF can adopt a ‘priority distribution model’, in which one class of investors share a loss which is more than what should be borne based on their pro-rata holding in the fund, as other class of investors have priority in distribution over such one class of investors. Any AIF scheme which has adopted the priority distribution model shall not accept fresh commitments or make investments in a new investee company, until SEBI gives further clarification in this regard.

The table below provides an indicative process of the Fund-raising activity, for an AIF.

Table14.1: Fund-raising Process

Sr. No.	Action	Particulars
Step 1	Fund Formation with all Fund Constituents	Sponsor and/or Investment Manager should form a legal entity and form a trust for the said fund by appointing a Trustee, Custodian, fund accountant, Registrar and Transfer Agents and advisors.

¹⁴⁵ Not applicable to Accredited Investors, as per SEBI (Alternative Investment Funds) (Third Amendment) Regulations, 2021

¹⁴⁶ SEBI Circular No.: CIR/IMD/DF/14/2014 dated June 19, 2014 on Guidelines on disclosures, reporting and clarifications under AIF Regulations.

Sr. No.	Action	Particulars
Step 2	Apply for SEBI Registration	File PPM and make application in specified format (Form A).
Step 3	Receive SEBI In-principle Approval	Based on initial application filed, SEBI grants in-principle approval. This is followed by opening of bank accounts custody accounts, registration at SCORES platform and getting SEBI Login for the fund to accept capital contributions.
Step 4	Appoint Distributors and Initiate taking Capital Commitments from Investors	After receiving in-principle approval, the fund can approach investors to raise capital commitments, but not raise money.
Step 5	Obtain SEBI Registration Certificate	Receive Registration Certificate in Form B after paying registration fees and application fees.
Step 6	First Close	Obtain target capital commitments and/or on-board investors, receive initial capital call money, start investing and declaring NAV.
Step 7	Make Capital Calls during Drawdown Period, if any	If the AIF has drawdowns, make the remaining capital calls, start investing and declaring NAV.
Step 8	Final Close	Approach investors to achieve total targeted fund corpus and close the fund-raising activity.

14.9 Investment Conditions applicable to AIFs

14.9.1 General Investment Conditions for all AIFs

All AIFs shall state investment strategy, investment purpose and its investment methodology in its PPM to the investors. Any material alteration to the fund strategy shall be made with the consent of at least two-thirds of unit holders by value of their investment in the AIF or the respective scheme.

Foreign Investment: AIFs may invest in securities of companies incorporated outside India subject to FEMA and such conditions or guidelines that may be stipulated or issued by the RBI and SEBI from time to time.

AIFs can invest in securities of companies incorporated outside India by filing an application with SEBI for allocation of overseas investment limit in the format specified by SEBI.¹⁴⁷ The Sponsor or Manager of such AIF shall further submit an undertaking to SEBI in this regard.

¹⁴⁷ SEBI Circular No.: SEBI/HO/AFD-1/PoD/CIR/P2022/108 dated August 17, 2022 on Guidelines for overseas investment by AIFs/VCFs.

AIFs shall invest in an overseas investee company, which is incorporated in a country whose securities market regulator is a signatory to the IOSCO's Multilateral Memorandum of Understanding (Appendix A Signatories) or a signatory to the bilateral Memorandum of Understanding with SEBI.

AIFs cannot invest in an overseas investee company, which is incorporated in a country identified in the public statement of Financial Action Task Force (FATF) as:

- a jurisdiction having a strategic Anti-Money Laundering or Combating the Financing of Terrorism deficiencies to which counter measures apply, or
- a jurisdiction that has not made sufficient progress in addressing the deficiencies or has not committed to an action plan developed with FATF to address the deficiencies.

If an AIF liquidates its investment made in an overseas investee company previously, the sale proceeds received from liquidation to the extent of investment made in the company, shall be available to all other AIFs for reinvestment, including the selling AIF. The AIF must sell its investment in the overseas company only to the entities eligible to make overseas investments, as per Foreign Exchange Management Act, 1999. The AIF shall furnish details of sale or divestment of investments in overseas companies to SEBI within 3 working days of such sale or divestment. The AIF shall furnish the details by emailing to aifreporting@sebi.gov.in, so that SEBI can update the overall limit available for overseas investment by AIFs.

Raising Capital: SEBI (Alternative Investment Funds) Regulations states that a registered AIF can raise capital commitments from any investor, whether Indian investors, Foreign Investors or Non-Resident Indian Investors. At the time of onboarding investors, the investment manager of an AIF shall ensure that¹⁴⁸ Foreign investors in the AIF are a resident of the country:

- whose securities market regulator is a signatory to the International Organization of Securities Commission's (IOSCO) Multilateral Memorandum of Understanding (Appendix A Signatory), or
- which is a signatory to the bilateral Memorandum of Understanding between SEBI and any authority outside India that provides for information sharing arrangement as specified under the SEBI Act, 1992.

Any government or government-related investor, who does not meet the aforesaid condition, but is a resident in the country as may be approved by the Government of India.

Any foreign investor or its beneficial owner, as determined under PML (Maintenance of Records) Rules, shall not be mentioned in the Sanctions List notified by the United Nations

¹⁴⁸SEBI Circular No.: SEBI/HO/AFD-1/PoD/P/CIR/2022/171 dated December 9, 2022 on Foreign investment in AIFs.

Security Council (UNSC).¹⁴⁹ Further, such fund or its beneficial owner shall not be a resident of a country identified in the public statement of Financial Action Task Force (FATF) as:

- a jurisdiction having a strategic Anti-Money Laundering (AML) or Combating the Financing of Terrorism (CFT) deficiencies to which counter measures apply; or
- a jurisdiction that has not made sufficient progress in addressing the deficiencies or has not committed to an action plan developed with the FATF to address the deficiencies.

In case existing investors in the AIF do not meet the aforesaid conditions, the manager of the fund shall not drawdown any further capital contribution from such investors for making investment, until the investors meet the said conditions.

Exclusion of an Investor: An AIF may excuse or exclude its investor from participating in a particular investment in the following circumstances:¹⁵⁰

- Based on legal opinion, if the investor confirms that participation in such investment would be in violation of an applicable law or regulation.
- If the investor has disclosed in the Contribution Agreement that participation in such investment would be in contravention to the internal policy of the investor. In such case, the Manager should also ensure that terms of the Contribution Agreement include reporting of any change in the disclosed internal policy, to the fund manager within 15 days of such change.
- If the AIF Manager is satisfied that the participation of such investor in the investment opportunity would lead to the AIF scheme being in violation of any applicable law or regulation or would adversely affect the AIF scheme. The manager shall record the rationale for such exclusion, along with supporting documents.
- If such investor is an investment vehicle like a fund, such fund may be partially excused from participation in an investment opportunity to the extent of the capital contribution of such fund's investors who are to be excused from such investment opportunity. The manager shall record the rationale for such excuse or exclusion, along with supporting documents.

Co-Investment: The terms of Co-investment in an investee company by a Manager or Sponsor or co-investor, shall not be more favourable than the terms of investment of the AIF. The terms of exit from the Co-investment in an investee company including the timing of exit shall be identical to the terms applicable to that of exit of the AIF.

¹⁴⁹ SEBI Circular No.: SEBI/HO/AFD/PoD1/CIR/2024/2 dated January 11, 2024 on Foreign investment in AIFs.

¹⁵⁰ SEBI Circular No.: SEBI/HO/AFD-1/PoD/P/CIR/2023/053 dated April 10, 2023 on Guidelines with respect to excusing or excluding an investor from an investment of AIF.

General Investment Conditions: Category I and II AIFs shall invest not more than 25% of the investable funds in one Investee Company directly or through investment in the units of other AIFs.¹⁵¹ Such Category I and II AIFs may invest in units of other AIFs without labelling themselves as a Fund of AIFs.¹⁵² However, large value funds for accredited investors of Category I and II AIFs may invest up to 50% of the investable funds in an investee company directly or through investment in the units of other AIFs.¹⁵³ Investable funds means corpus of the scheme of AIF net of expenditure for administration and management of the fund estimated for the tenure of the fund.¹⁵⁴

Existing AIFs may also invest simultaneously in securities of investee companies and in units of other AIFs, subject to appropriate disclosures in the PPM and with the consent of at least two-thirds of unit holders by value of their investment in the AIF.

AIFs which are authorised under the fund documents to invest in units of AIFs shall not offer their units for subscription to other AIFs.¹⁵⁵

AIF shall not invest in associates or in units of other AIFs managed or sponsored by its Manager, Sponsor or associates of its Manager or Sponsor, except with the approval of 75% of investors by value of their investment in the AIF.

Except with the approval of 75% of investors by value of their investment in the AIF, an AIF scheme shall not buy or sell investments to associates or to schemes of AIFs managed or sponsored by its Manager, Sponsor or associates of its Manager or Sponsor. Further, the AIF should not buy or sell investments to an investor who has committed to invest at least fifty percent of the corpus of the scheme of the AIF, and such investor must be excluded from the voting process to get the necessary approval of 75% of investors by value of their investment in the AIF.

Un-invested portion of the investable funds and divestment proceeds pending distribution to investors may be invested in liquid mutual funds or bank deposits or other liquid assets of higher quality such as Treasury bills, Triparty Repo Dealing and Settlement, Commercial Papers, Certificates of Deposits, etc. till the deployment of funds as per the investment

¹⁵¹ Such limits do not apply to Category I AIF/Category II AIF domiciled in IFSC, provided appropriate disclosures have been made in the PPM and the investments by AIFs are in line with the risk appetite of the investors.

¹⁵² Vide SEBI Circular No. SEBI/HO/IMD-I/DF6/P/CIR/2021/584 dated June 25, 2021 on Amendment to SEBI (AIF) Regulations, 2012.

¹⁵³ Vide SEBI (Alternative Investment Funds) (Third Amendment) Regulations, 2021 w.e.f. August 3, 2021.

¹⁵⁴ SEBI (Alternative Investment Funds) (Fourth Amendment) Regulations, 2018 w.e.f. August 13, 2021

¹⁵⁵ Vide SEBI (Alternative Investment Funds) (Second Amendment) Regulations, 2021 w.e.f. August 5, 2021.

objective, or the distribution of the funds to investors as per the terms of the fund documents.¹⁵⁶

AIF may act as Nominated Investor as specified in SEBI (Issue of Capital and Disclosure Requirements) Regulations. This is in connection with public issues made by SME companies.

Investment by Category I and Category II AIFs in the shares of entities listed on institutional trading platform (SMEs) shall be deemed to be investment in 'unlisted securities'.

AIFs can also transact in Corporate Bonds through the Request for Quote (RFQ) platform of stock exchanges.¹⁵⁷ To enhance transparency and disclosure of trades in the secondary market for Corporate Bonds, AIFs shall undertake at least 10 percent of their total monthly secondary market trades in Corporate Bonds by placing/seeking quotes on the RFQ platform. Quotes on the RFQ platform can be placed to an identified counterparty (on a 'one-to-one' mode) or to all the participants (on a 'one-to-many' mode).¹⁵⁸ If the AIF is on both sides of a trade in Corporate Bonds through RFQ Platform, then the transactions shall be executed in 'one-to-one' mode. If an AIF enters a transaction in 'one-to-many' mode and gets executed with another AIF, then such transaction shall be counted in 'one-to-many' mode and not in 'one-to-one' mode.

Investments of AIFs in dematerialised form: AIFs are required to hold their investments in dematerialised form, subject to conditions specified by SEBI from time to time. However, condition for holding investments in dematerialisation form does not apply in the following cases:¹⁵⁹

- a. investments by AIFs in such type of instruments which are not eligible for dematerialisation
- b. investments held by a liquidation scheme of the AIFs that are not available in the dematerialised form
- c. such other investments by AIFs and such other schemes of AIFs as may be specified by the SEBI from time to time

SEBI has also clarified that any investment made by an AIF on or after July 1, 2024 shall be held in dematerialised form only, irrespective of whether the investment is made directly in the investee company or is acquired from another entity.¹⁶⁰

¹⁵⁶ Vide SEBI (Alternative Investment Funds) (Fourth Amendment) Regulations, 2018 w.e.f. August 13, 2021.

¹⁵⁷ SEBI Circular No.: SEBI/HO/AFD/PoD/P/CIR/2023/017 dated February 1, 2023 on Transaction in Corporate Bonds through Request for Quote (RFQ) platform by AIFs.

¹⁵⁸ SEBI Circular No.: SEBI/HO/DDHS/DDHS_Div1/P/CIR/2022/142 dated October 19, 2022.

¹⁵⁹ Vide SEBI (AIF) (Amendment) Regulations, 2024 w.e.f. January 5, 2024.

¹⁶⁰ SEBI Circular Nos.: SEBI/HO/AFD/PoD/CIR/2024/5 dated January 12, 2024 and SEBI/HO/AFD/PoD-1/P/CIR/2025/17 dated February 14, 2025.

14.9.2 Specific Investment Conditions for Category I AIFs

The below investment conditions are applicable to all Category I Alternative Investment Funds:

1. Category I AIF shall invest in investee companies, venture capital undertakings (VCU), special purpose vehicles, limited liability partnerships, units of other Category I AIFs of the same sub-category or scheme or in units of Category II AIFs.¹⁶¹
2. Category I AIF may engage in hedging, including buying credit default swaps, as per terms and conditions mentioned by SEBI from time to time.¹⁶²

No leveraging at fund level is permitted for Category I AIFs either directly or indirectly except for meeting temporary funding requirements for not more than 30 days, on not more than 4 occasions in a year and not more than 10 percent of the investable funds.¹⁶³

In order to facilitate ease of doing business and provide operational flexibility, Category I AIFs are allowed to borrow for the purpose of meeting temporary shortfall in amount called from investors for making investments in investee companies ('drawdown amount').¹⁶⁴ Such borrowings may be done only in case of emergency and as a last recourse, when the investment opportunity is imminent to be closed and the drawdown amount from investor(s) has not been received by the AIFs before the date of investment, in spite of best efforts by manager to obtain the drawdown amount from the delaying investor(s). The cost of such borrowings will be charged only to the delaying investor(s). AIFs need to maintain 30 days cooling off period between two periods of borrowing. The cooling off period is calculated from the date of repayment of previous borrowing.

In addition to the above, the following investment conditions are applicable for **Venture Capital Funds (VCF)**:

1. At least 75% of the investable funds shall be invested, by the end of the fund life-cycle, in unlisted equity shares or equity linked instruments of a VCU or in companies listed or proposed to be listed on a SME exchange or SME segment of an exchange.¹⁶⁵

¹⁶¹ SEBI (Alternative Investment Funds) (Second Amendment) Regulations, 2021 w.e.f. May 5, 2021.

¹⁶² Vide SEBI (AIF) (Amendment) Regulations, 2023 w.e.f. January 9, 2023.

¹⁶³ However, these restrictions do not apply to Category I AIF/Category II AIF domiciled in IFSC. They are permitted to take leverage, provided the maximum leverage, along with the methodology for calculation of leverage, is disclosed in the placement memorandum, subject to consent of the investors and the fund has a comprehensive risk management framework appropriate to the size, complexity and risk profile of the fund.

¹⁶⁴ SEBI Circular No. SEBI/HO/AFD/AFD-POD-1/P/CIR/2024/112 dated August 19, 2024.

¹⁶⁵ SEBI (Alternative Investment Funds) (Second Amendment) Regulations, 2018 w.e.f. August 13, 2021.

2. Venture Capital funds may enter into an agreement with merchant banker to subscribe to the unsubscribed portion of the issue or to receive or deliver securities in the process of market making for SME issues, as per Chapter IX of the SEBI (Issue of Capital and Disclosure Requirements) Regulations.
3. Venture Capital funds shall be exempt from sub-regulations (1) and (2) of regulation 3 and sub-regulation (1) of regulation 4 of SEBI (Prohibition of Insider Trading) Regulations, 2015 in respect of investment in companies listed on SME Exchange or SME segment of an exchange pursuant to due diligence of such companies subject to the following conditions:¹⁶⁶
 - a. the fund shall disclose any trading in securities pursuant to such due-diligence, within two working days of such trading, to the stock exchanges where the investee company is listed;
 - b. such investment shall be locked in for a period of one year from the date of investment.

The following specific additional conditions shall apply to **SME Funds**:

1. At least 75% of the investable funds shall be invested in unlisted securities or partnership interest of VCU's or investee companies which are SMEs or in companies listed or proposed to be listed on SME exchange or SME segment of an exchange, or in units of Category II AIFs which invest primarily in such venture capital undertakings or investee companies.¹⁶⁷
2. These funds may enter into an agreement with merchant banker to subscribe to the unsubscribed portion of the issue or to receive or deliver securities in the process of market making for such issues, as per Chapter IX of the SEBI (Issue of Capital and Disclosure Requirements) Regulations.
3. SME funds shall be exempt from sub-regulations (1) and (2) of regulation 3 and sub-regulation (1) of regulation 4 of SEBI (Prohibition of Insider Trading) Regulations, 2015 in respect of investment in companies listed on SME Exchange or SME segment of an exchange pursuant to due diligence of such companies subject to the following conditions:
 - a) the fund shall disclose any trading in securities pursuant to such due-diligence, within two trading days of such trading, to the stock exchanges where the investee company is listed;
 - b) such investment shall be locked in for a period of one year from the date of investment.

¹⁶⁶ SEBI (Alternative Investment Funds) (Fourth Amendment) Regulations, 2018, w.e.f. August 13, 2021.

¹⁶⁷ SEBI (Alternative Investment Funds) (Fourth Amendment) Regulations, 2018, w.e.f. August 13, 2021.

The following additional specific conditions shall apply to **Social Impact Funds**:

1. At least 75% of the investable funds shall be invested in unlisted securities or partnership interest of social ventures or in units of social ventures or in securities of social enterprises. An existing social impact fund may invest the remaining investable funds in securities of not-for-profit organizations registered or listed on a social stock exchange with the prior consent of at least 75% of the investors by value of their investment
2. These funds may accept grants, provided that such utilisation of such grants shall be as per the condition stated above and the minimum grant from any person shall not be less than INR 10 lakh. However, the minimum amount of grant shall not be applicable to accredited investors.¹⁶⁸ No profits or gains may be attributed to the provider of such grants.
3. A social impact fund or schemes of a social impact fund launched exclusively for a not-for-profit organization registered or listed on a social stock exchange, shall be permitted to deploy or invest 100% of the investable funds in the securities of not-for-profit organizations registered or listed on a social stock exchange.
4. Such funds may give grants to social ventures or social enterprises, provided that appropriate disclosure is made in the PPM.

The following additional specific conditions shall apply to **Infrastructure Funds**:

1. At least 75% of the investable funds shall be invested in unlisted securities or units or partnership interest of VCUs or investee companies or special purpose vehicles, which are engaged in or formed for the purpose of operating, developing or holding infrastructure projects, or in units of Category II AIFs which invest primarily in such venture capital undertakings or investee companies or special purpose vehicles.
2. Notwithstanding the restriction stated in above point, Infrastructure funds may also invest in listed securitised debt instruments or listed debt securities of such investee companies or special purpose vehicles which are engaged in or formed for the purpose of operating, developing or holding infrastructure projects.

14.9.3 Specific Investment Conditions for Category II AIFs

1. Category II AIFs shall invest primarily in unlisted investee companies, directly or through investment in units of other AIFs. Category II AIFs shall invest in investee

¹⁶⁸ SEBI (Alternative Investment Funds) (Fourth Amendment) Regulations, 2018, w.e.f. August 13, 2021.

companies or in the units of other Category I or Category II AIFs as may be disclosed in the placement memorandum.¹⁶⁹

2. No leveraging at fund level is permitted for Category II AIFs either directly or indirectly except for meeting temporary funding requirements for not more than 30 days, on not more than 4 occasions in a year and not more than 10 percent of the investable funds. However, Category II AIFs may engage in hedging, subject to guidelines as may be specified by SEBI from time to time.
3. However, in order to facilitate ease of doing business and provide operational flexibility, Category II AIFs are allowed to borrow for the purpose of meeting temporary shortfall in amount called from investors for making investments in investee companies ('drawdown amount').¹⁷⁰ Such borrowings may be done only in case of emergency and as a last recourse, when the investment opportunity is imminent to be closed and the drawdown amount from investor(s) has not been received by the AIFs before the date of investment, in spite of best efforts by manager to obtain the drawdown amount from the delaying investor(s). The cost of such borrowings will be charged only to the delaying investor(s). AIFs need to maintain 30 days cooling off period between two periods of borrowing. The cooling off period is calculated from the date of repayment of previous borrowing.
4. Category II AIFs may buy or sell credit default swaps in terms of the conditions as may be specified by SEBI from time to time.¹⁷¹
5. Category II AIFs may enter into agreement with merchant banker to subscribe to the unsubscribed portion of the issue or to receive or deliver securities in the process of market making, as per Chapter IX of the SEBI (Issue of Capital and Disclosure Requirements) Regulations, 2018.
6. Category II AIFs shall be exempt from sub-regulations (1) and (2) of regulation 3 and sub-regulation (1) of regulation 4 of SEBI (Prohibition of Insider Trading) Regulations, 2015 in respect of investment in companies listed on SME Exchange or SME segment of an exchange pursuant to due diligence of such companies subject to the following conditions:
 - i. the fund shall disclose any trading in securities pursuant to such due-diligence, within two trading days of such trading, to the stock exchanges where the investee company is listed
 - ii. such investment shall be locked in for a period of 1 year from the date of investment.

¹⁶⁹ SEBI (Alternative Investment Funds) (Second Amendment) Regulations, 2021 w.e.f. May 5, 2021.

¹⁷⁰ SEBI Circular No. SEBI/HO/AFD/AFD-POD-1/P/CIR/2024/112 dated August 19, 2024.

¹⁷¹ Vide SEBI (Alternative Investment Funds) (Amendment) Regulations, 2023 w.e.f. January 9, 2023.

14.9.5 Special Dispensation for Angel Funds

SEBI has stipulated a special dispensation for Angel Funds as a sub-category of Venture Capital Fund under Category I AIF. This is because angel investments are made at a very early stage in the life cycle of a business and require more flexibility.

Essentially angel investors are high net worth individuals (HNIs) who invest in their individual capacity or through their family offices with own funds. Typically, angel investors seek equity representation in a start-up with the intention of exiting only if and when the venture succeeds. Since such businesses entail high risk of mortality, the term 'angel investor' was coined in USA to describe them more as benefactors and less as commercial investors. In most situations, start-up ventures find it difficult to establish the required confidence for VC funds to invest or banks to lend to them. Therefore, angels take the high risk and address the critical financing gap in the initial formative phase of a start-up business venture.

According to the AIF Regulations, an angel investor is defined as

- i. an individual investor who has net tangible assets of at least INR 2 crore excluding value of his principal residence, and who has early-stage investment experience, or has experience as a serial entrepreneur or is a senior management professional with at least 10 years of experience. (Further, early-stage investment experience is defined as prior experience in investing in start-up or emerging or early-stage ventures and 'serial entrepreneur' shall mean a person who has promoted or co-promoted more than one start-up venture.); or
- ii. a body corporate with a net worth of at least INR 10 crore; or
- iii. an AIF registered under SEBI (AIF) Regulations, 2012 or Venture Capital Fund (VCF) registered under the SEBI (VCF) Regulations, 1996.

In recent years, angel investment has also got organised whereby fund managers have started angel funds to pool capital from high net-worth angel investors so as to bring the advantage of active fund management to angel stage investments. Angel funds typically have the same organisational structure and similar investment processes as those described for venture capital and private equity funds. An angel fund is defined under the Regulations as a sub-category of venture capital fund under Category I AIF that raises funds from angel investors and invests in accordance with the provisions of Chapter III-A of SEBI (AIF) Regulations.

1. **Formation and Corpus Creation** - An Angel Fund requires to be registered specifically as an angel fund with SEBI though it is a sub-category of Category I AIF. Any registered

Category I AIF that has not made any investments may apply to SEBI for conversion of its category into an Angel Fund. Angel funds shall raise funds only by issuing units to angel investors through private placement by issue of PPM. An angel fund shall have a corpus of at least INR 5 crore. It shall accept, up to a maximum period of 5 years, an investment of not less than INR 25 lakh from a single angel investor.

2. **Schemes and Listing** – Angel Funds may launch schemes subject to filing of a term sheet with SEBI, containing material information regarding the scheme, in the format and time period as may be specified by SEBI. No scheme of the angel fund shall have more than 200 angel investors (if it is a company, it shall be subject to the Companies Act 2013). Units of angel funds shall not be listed on any recognised stock exchange.
3. **Investment Restrictions** –
 - i. Angel funds shall invest in start-ups which:
 - a. are not promoted or sponsored by or related to an industrial group whose group turnover exceeds INR 300 crore.¹⁷²
 - b. are not companies with family connection with any of the angel investors who are investing in the company.
 - ii. Investment by an angel fund shall not be less than INR 25 lakh and shall not exceed INR 10 crore in one investee company (venture capital undertaking)
 - iii. Investment by an angel fund shall be locked-in for a period of 1 year.
 - iv. Angel funds shall not invest in associates. As per SEBI (AIF) Regulations, an associate means a company or a limited liability partnership or a body corporate in which a director or trustee or partner or Sponsor or Manager of the AIF or a director or partner of the Manager or Sponsor holds, either individually or collectively, more than fifteen percent of its paid-up equity share capital or partnership interest.
 - v. Angel funds shall not invest more than 25 percent of the total investments under all its schemes in a single entity, provided that the compliance to this sub-regulation shall be ensured by the Angel Fund at the end of its tenure.
 - vi. An angel fund may also invest in the securities of companies incorporated outside India subject to conditions or guidelines issued by the RBI and SEBI from time to time.
 - vii. The manager or sponsor shall have a continuing interest in the angel fund of not less than 2.5 percent of the corpus or INR 50 lakh, whichever is lesser, and such interest shall not be through the waiver of management fees.

¹⁷² Industrial group includes a group of body corporates with the same promoter(s)/ promoter group, a parent company and its subsidiaries, a group of body corporates in which the same person/ group of persons exercise control, and a group of body corporates comprised of associates/ subsidiaries/ holding companies.

- viii. Prior to making investments, the manager of the angel fund shall obtain prior approvals from the angel investors.

14.9.6 Special Dispensation for Special Situation Funds¹⁷³

SEBI has stipulated a special dispensation for Special Situation Funds (SSF) as a sub-category of Category I AIF. This is because special situation funds can play a vital role to decrease the impact of bad loans on banks. In this regard, SEBI has detailed out certain exemptions for SSFs from investment concentration norm in a single investee company and permitting to invest its investable funds in unlisted or listed securities of the investee company.

“Special Situation Fund” means a Category I AIF that invests in special situation assets in accordance with its investment objectives and may act as a resolution applicant under the Insolvency and Bankruptcy Code (IBC), 2016. Special situation asset includes:

- a. Stressed Loans available for acquisition in terms of Clause 58 of Master Direction – RBI (Transfer of Loan Exposure) Directions, 2021 or as part of a resolution plan approved under the Insolvency and Bankruptcy Code, 2016, or in terms of any other policy of the RBI or Government of India.¹⁷⁴
- b. Security Receipts issued by an Asset Reconstruction Company (ARC) registered with the RBI.
- c. Securities of investee companies whose stressed loans are available for acquisition in terms of RBI’s Master Direction or as part of a resolution plan approved under the Insolvency and Bankruptcy Code, 2016.
- d. Securities of investee companies against whose borrowings, security receipts have been issued by an ARC or whose borrowings are subject to corporate insolvency resolution process under Insolvency and Bankruptcy Code, 2016. The credit rating of such borrowings should be downgraded to “D” or equivalent.
- e. Securities of investee companies who have disclosed defaults relating to interest and principal payments on loans from banks, financial institutions, non-banking financial companies and debt securities, in terms of SEBI (Issue of Capital and Disclosure Requirements) Regulations, 2018 and such payment default is continuing for at least ninety calendar days after the occurrence of such default. The credit rating of such loans and debt securities should be downgraded to “D” or equivalent.

¹⁷³ Vide SEBI (Alternative Investment Funds) (Amendment) Regulations, 2022 w.e.f. January 24, 2022.

¹⁷⁴ As per Clause 58 of the Master Direction, acquisition of stressed loans can be done by permitted entities and Asset Reconstruction Companies (“ARCs”) as a part of resolution plan under the Reserve Bank of India (Prudential Framework for Resolution of Stressed Assets) Directions, 2019, resulting in an exit of all lenders. The Master Circulars also lays down conditions of transfer to non-permitted entities.

Investment in Special Situation Funds (SSF):

- Each scheme of a special situation fund shall have a minimum corpus of INR 100 crore.¹⁷⁵
- The minimum investment by an investor in an SSF should be INR 10 crore and INR 5 crore in case of an Accredited Investor. In case of investments by employees or directors of the SSF, or employees or directors of investment manager of the SSF, the minimum amount of investment should be INR 25 lakh.
- The special situation fund shall not accept investments from any other AIF, other than a special situation fund.

Investment by Special Situations Funds (SSF):

Special Situation Funds shall invest only in special situation assets and may act as a resolution applicant under the Insolvency and Bankruptcy Code, 2016. An SSF intending to act as a Resolution Applicant shall ensure compliance with the eligibility requirements, as per the Insolvency and Bankruptcy Code, 2016.

A Special Situation Fund should not invest in its associates, or in the units of any other Alternative Investment Fund (except in units of a special situation fund), or in units of special situation funds managed or sponsored by its manager, sponsor or associates of its manager or sponsor.

In case a Special Situation Fund (SSF) acquires stressed loans, in terms of Clause 58 of Master Direction – RBI (Transfer of Loan Exposure) Directions, 2021:

- The fund can acquire stressed loans in terms of afore-mentioned clause, upon inclusion of SSF in the respective Annex of the RBI Master Direction
- The stressed loans acquired shall be subject to a minimum lock-in period of 6 months. The lock in period shall not be applicable in case of recovery of the stressed loan from the borrower
- The fund acquiring stressed loans shall comply with the same initial and continuous due diligence requirements for investors, as those mandated by RBI for investors in an Asset Reconstruction Company.

¹⁷⁵ Vide SEBI Circular No. SEBI/HO/IMD-I/DF6/P/CIR/2022/009 dated January 27, 2022 on Introduction of Special Situation Funds as a sub-category under Category I AIFs.

14.9.7 Special Dispensation for Corporate Debt Market Development Funds

SEBI has stipulated a special dispensation for Corporate Debt Market Development Fund (CDMDF), with the intent:

- to have a backstop facility for purchase of investment grade corporate debt securities,
- to instil confidence amongst the participants in the Corporate Debt Market during times of stress, and
- to generally enhance secondary market liquidity by creating a permanent institutional framework for activation in times of market stress.

A Corporate Debt Market Development Fund shall be registered under SEBI (AIF) Regulations by filing a PPM and being constituted as a Trust, as per provisions of the Indian Registration Act, 1908. The fund should have a tenure of 15 years from date of first close and shall be formed as a close-ended AIF. The tenure of the fund may be extended or the fund may be wound up only on prior approval of SEBI.

A Corporate Debt Market Development Fund shall comply with the Guarantee Scheme for Corporate Debt (GSCD) as notified by Ministry of Finance vide notification no. G.S.R. 559(E) dated July 26, 2023. In addition to the scheme, the fund must:

- Deal only in low duration Government Securities, Treasury Bills, Tri-party Repos on Government Securities or Guaranteed Corporate Bond Repos with maturity not exceeding 7 days.
- Charge specified fees and expenses.

Portfolio Value means the aggregate amount of portfolio of investments including cash balance without netting-off leverage undertaken by the Fund. Taxes should cover all kinds of statutory taxes. Transaction costs on securities such as brokerage, clearing charges etc. shall be charged within the limit of fees and expenses. Financing charges pertaining to borrowings made (such as interest, guarantee fees, other fees like bank charges, processing fees etc.) may be separate from fees and expenses of the fund.

Investment in the Corporate Debt Market Development Fund (CDMDF):

Investments in units of a CDMDF shall be made by Asset Management Companies (AMCs) and specified debt-oriented schemes of mutual funds, as per the provisions of the Securities and Exchange Board of India (Mutual Funds) Regulations, 1996. The Manager or Sponsor of the CDMDF shall have a continuing interest of not less than INR 5 crore in the form of investment and such continuing interest shall not be through the waiver of management fees.

Investment Conditions for Corporate Debt Market Development Fund (CDMDF):

During periods of market dislocation, as per triggers decided by SEBI, the Corporate Debt Market Development Fund shall purchase corporate debt securities from specified debt-oriented schemes of mutual funds which meet the following eligibility criteria:

- corporate debt securities shall be listed and have an investment grade rating;
- the residual maturity of such securities shall not exceed five years on the date of purchase;
- securities with no material possibility of default or adverse credit news or views.

The Corporate Debt Market Development Fund shall purchase corporate debt securities in proportion to the contribution made in it at a mutual fund level, as per detailed guidelines of SEBI. These securities should be held till maturity or sold in the secondary market upon reversal of market dislocation, when specified by SEBI. The fund shall buy corporate debt securities at fair price adjusted for liquidity risk, interest rate risk and credit risk but not at distress prices. Further, the Corporate Debt Market Development Fund shall follow the Fair Pricing document while purchase of corporate debt securities during market dislocation and follow the loss waterfall accounting mechanism.¹⁷⁶

Corporate debt securities to be bought by CDMDF during market dislocation include listed money market instruments. The long-term rating of issuers shall be considered for the money market instruments. If there is no long-term rating available for the issuer, then based on credit rating mapping of Credit Rating Agencies between short term and long-term ratings, the most conservative long-term rating shall be taken for a given short-term rating.

If there is no market dislocation, the Corporate Debt Market Development Fund shall invest in liquid and low-risk debt instruments and undertake any other activity related to corporate debt market, as may be specified by SEBI.

The Corporate Debt Market Development Fund shall not invest in the securities of companies incorporated outside India. Investments made by the fund in one company should not exceed five percent of its fund capital at the time of investment. The combined investment in the corporate debt securities of an issuer group, as specified under SEBI (Mutual Funds) Regulations, shall not exceed seven and half percent of its fund capital at the time of investment. Fund Capital shall be the aggregate of the corpus of the fund and maximum permissible borrowing for the fund.

The Corporate Debt Market Development Fund may borrow funds up to ten times its corpus, subject to conditions set by SEBI, in consultation with the Government of India.

The portfolio of the fund shall be disclosed to the unitholders on a fortnightly basis and the NAV of the fund should be disclosed to the unitholders daily. The Fund shall disclose its NAV by 9:30 PM on all business days on website of its Investment Manager and AMFI. For times

¹⁷⁶ As per SEBI Circular SEBI/HO/IMD/PoD2/P/CIR/2023/128, dt. July 27, 2023

when the fund would have exposure to corporate debt, such NAV shall be disclosed by 11 PM on all business days.

Valuation procedure and methodology for valuing assets of the Fund shall be governed by the norms applicable to Mutual Fund schemes. In-specie distribution of assets of the fund may be made to the unit holders, only at the time of winding up subject to the consent of seventy-five percent of the unit holders by value of their investment in such fund. Sharing of loss by the sellers of corporate debt securities to the Corporate Debt Market Development Fund during periods of market dislocation may be higher than their pro rata holding in the Alternative Investment Fund vis-à-vis other unit holders.

The units of the Corporate Debt Market Development Fund shall not be listed on any recognised stock exchange.

Governance Mechanism for Corporate Debt Market Development Fund (CDMDF):

The Corporate Debt Market Development Fund shall appoint a trustee company, with similar roles and responsibilities assigned to trustees under SEBI (Mutual Funds) Regulations. The Board of directors of trustee company and the Manager of the fund shall be appointed with the prior approval of SEBI. The Trustee Company shall not engage in any activity other than acting as a trustee of the CDMDF. Only with written consent from SEBI, the trustee company can engage in any other activity which is not in conflict with its role as the trustee of the CDMDF. An audit committee of the trustee company shall be constituted to review compliance with the provisions of PPM, along with other responsibilities as may be specified by SEBI. Two-thirds of the members of the board of directors of the trustee company shall be independent directors and shall not be associated with the Sponsor or the Manager of the CDMDF.

The fund manager shall appoint a Governance Committee. This Committee shall comprise corporate bond market experts including academicians, fund managers or Chief Investment Officers, risk management professionals and independent market experts. The Committee, jointly with the board of the Manager and trustee company, shall approve the policies of the fund. The Committee shall supervise the activities of the fund, especially relating to management of conflict of interest, if any. The Committee shall have oversight on management of asset liability mismatches during times of market dislocation.

The Manager of Corporate Debt Market Development Fund shall continue to be responsible for any liabilities, that may arise out of the mandate in relation to its investment management activities.

17.9.8 Participation in Credit Default Swaps¹⁷⁷

A Credit Default Swap (CDS) is a credit derivative contract in which one counterparty (protection seller) commits to pay to the other counterparty (protection buyer) in the case of a credit event with respect to a reference entity and in return, the protection buyer makes periodic payments (premium) to the protection seller until the maturity of the contract or the credit event, whichever is earlier. The Reference Entity is an entity against whose credit risk, a credit derivative contract is entered into.¹⁷⁸

Category I AIFs and Category II AIFs may buy CDS on underlying investment in debt securities, only for the purpose of hedging.

Category II AIFs may sell CDS by earmarking unencumbered Government bonds/Treasury bills equal to the amount of the said CDS exposure. Such earmarked securities may also be used for maintaining applicable margin requirements for the said CDS exposure and shall not be considered to compute the leverage limit of the AIF scheme. Further, the total exposure to one investee company, including the exposure through CDS, shall be within the concentration limits applicable to Category II AIFs, as mentioned in the SEBI (Alternative Investment Funds) Regulations.

CDS exposures taken by AIFs shall be reported to the custodian by the next working day. The Custodian shall put in place a mechanism to collect necessary details from AIFs transacting in CDS, to monitor the compliance with leverage limits and concentration limits applicable to such AIFs. In case of breach of leverage limits due to transactions in CDS by AIFs, the reporting obligation and necessary actions vest on the manager/AIF and the Custodian.¹⁷⁹

If a Category II AIF sells CDS by earmarking securities and in case the amount of earmarked securities falls below the CDS exposure, then:

- The AIF shall send a report to the custodian on the same day of the breach.
- The AIF shall bring the amount of earmarked securities equal to CDS exposure and report details regarding rectification of breach to custodian, by the end of next trading day.
- In case the AIF fails to rectify the breach in the manner as specified above, the custodian shall report details of the breach to SEBI, on the next working day.

If an AIF takes an unhedged position in a CDS, then the AIF should ensure that the gross unhedged positions are up to 25 percent of investable funds of the scheme. At the time of taking the unhedged position in a CDS, if the gross unhedged positions in CDS exceeds 25 percent of investable funds of the scheme, then such position should be taken only after intimating all the unit-holders in the fund.

¹⁷⁷SEBI Circular No.: SEBI/HO/AFD/PoD/CIR/2023/15 dated January 12, 2023 on Participation of AIFs in Credit Default Swaps.

¹⁷⁸Master Direction – Reserve Bank of India (Credit Derivatives) Directions, 2022 w.e.f. May 9, 2022.

¹⁷⁹ The obligation of manager/AIF and custodian in case of breach of leverage limits due to transactions in CDS by Category III AIFs, shall be as specified in para 3.4 of SEBI Circular No. CIR/IMD/DF/10/2013 dated July 29, 2013 read with para 1 of SEBI Circular No. CIR/IMD/DF/14/2014 dated June 19, 2014.

All CDS transactions shall be done on a platform regulated by SEBI or Reserve Bank of India (RBI), to enhance transparency and disclosure. AIFs transacting in CDS, shall also ensure compliance with applicable provisions of RBI notification on 'Master Direction – Reserve Bank of India (Credit Derivatives) Directions, 2022', dated February 10, 2022 and other directives issued by RBI in this regard from time to time.

14.11 General Obligations and Responsibilities of AIFs

14.10 Pro-rata and Pari-passu Rights of Investors¹⁸⁰

Pro-rata Rights of Investors: Investors in an AIF scheme shall have rights, pro-rata to their commitments to the scheme, in each investment to the scheme and in distribution of proceeds of such investment, except as may be specified by SEBI from time to time. The rights of investors in an AIF scheme issued prior to November 18, 2024, which are not pro-rata to their commitments to the scheme and not exempted by SEBI, shall be dealt with in a manner that is specified by SEBI.

The requirement of maintaining investors' rights pro-rata to their commitment to the scheme, shall not be applicable in an investment of a scheme and distribution of proceeds of the investment to the extent:

- An investor has been excused or excluded from participating in the investment. OR
- An investor has defaulted on providing pro-rata contribution for the investment.

The requirement of maintaining pro-rata rights of investors in distribution of proceeds of investments, shall not be applicable to the extent of returns/profits on investments which are shared with the investment manager, such as Performance Fees or Carried Interest, in terms of the Contribution Agreement.

The following entities may subscribe to a junior/subordinate class of units which accept lesser returns or share excess losses, as compared to their pro-rata rights in the investments made by the AIF scheme:

- Manager or Sponsor of the AIF
- Multilateral or Bilateral Development Financial Institutions
- State Industrial Development Corporations
- Entities established or owned or controlled by the Central Government or a State Government or the Government of a foreign country, including Central Banks and Sovereign Wealth Funds.

¹⁸⁰ Vide SEBI (Alternative Investment Funds) (Fifth Amendment) Regulations, 2024 w.e.f. November 18, 2024 and SEBI Circular No.: SEBI/HO/AFD/AFD-POD-1/P/CIR/2024/175 dated December 16, 2024.

This may enhance flexibility in fund raising from investors with varied risk appetite. If the Manager or Sponsor of AIF subscribes to the junior class of units, it shall be ensured that the amount invested by AIF scheme is not utilized by an investee company, directly or indirectly, to repay any obligations or liabilities towards the manager or sponsor of AIF, or their associates. This is commonly referred to as Evergreening of Liabilities/Loans, which is prohibited and unethical.

AIF schemes which have adopted a priority distribution model and have issued differential rights to their investors prior to November 18, 2024, shall not accept any fresh commitments or make investments in a new investee company, directly or indirectly. As a consequence, if the investment limits as per AIF Regulations are breached by such AIF schemes, such breach may not be considered as non-compliance with applicable provisions of AIF Regulations. However, the same shall be recorded in the Compliance Test Report prepared by the manager of the AIF Scheme.

Pari-passu Rights of Investors: Differential rights may be offered to select investors in the AIF scheme, without affecting the interest of other investors of the scheme, based on the following guiding principles:

- Such rights shall not result in any investor accruing a liability to other investors within the AIF scheme.
- Non-monetary or non-commercial rights shall not provide control to an investor in the decision-making process of the AIF Scheme, except when such investor is part of the Investment Committee.
- Such rights which should not alter the existing rights available to other investors in the AIF scheme
- All differential rights, and eligibility to avail the same, shall be transparently disclosed in the PPM of the AIF scheme.

AIF Managers and their key managerial personnel shall ensure the following while issuing differential rights to select investors:

- The differential rights shall be provided only in accordance with the implementation standards formulated by SFA.
- The following disclosures should be made in the PPM:
 - Eligibility criteria for an investor to avail each differential right, AND
 - How an eligible investor can opt for the differential right.

As per the PPM templates prescribed by SEBI, AIFs are required to disclose to all investors that any differential right offered to a specific investor(s), through separate classes of units or side letters/agreements, shall not have any adverse impact on the economic rights or any other rights of other investors. In this regard, the AIF schemes should comply with the following:

- The AIF manager shall report the details of differential right(s), which do not fall under the implementation standards formulated by SFA, in a prescribed format¹⁸¹ to SEBI and by emailing to aifreporting@sebi.gov.in, within specified timeline¹⁸²
- From the differential rights reported above, the manager shall immediately terminate those differential rights which are ascertained as affecting the rights of other investors

Pari-passu right of investors in an AIF Scheme does not apply to investors in a Large Value Fund for Accredited Investors (LVFs). Accordingly, new LVFs whose PPMs are filed with SEBI post December 13, 2024, may avail exemption from the requirement of maintaining pari-passu rights among investors, subject to the following:

- Making appropriate disclosure in the PPM, AND
- Obtain an undertaking from accredited investors with the following clause, at the time of on-boarding to LVF:
 - *“The prospective investor is aware that LVFs may avail exemption from the requirement of maintaining pari-passu rights among investors and therefore, may offer differential rights to select investors which might affect interest of others investors of the LVF.”*

Existing LVFs may avail exemption from the requirement of maintaining pari-passu rights among investors, subject to each investor of the scheme specifically providing the above-mentioned waiver clause.

The trustee/sponsor of AIF shall mention the above compliances in the Compliance Test Report submitted to SEBI.

Also, please refer Chapter 10 and Chapter 12 for the other general obligations and responsibilities of AIFs.

14.11 Inspection

SEBI may appoint one or more persons as Inspecting Authority to undertake inspection of the books of account, records and documents relating to an AIF, for any of the following reasons:

- to ensure that the books of account, records and documents are being maintained by the AIF in the manner specified by SEBI AIF Regulations.
- to inspect complaints received from investors, clients or any other person, on any matter having a bearing on the activities of the AIF

¹⁸¹ Format given at Annexure I of SEBI Circular No. SEBI/HO/AFD/AFD-POD-1/P/CIR/2024/175 dated December 13, 2024.

¹⁸² Vide SEBI Circular No.: SEBI/HO/AFD/AFD-PoD-1/P/CIR/2025/29 dated March 3, 2025.

- to ascertain whether the provisions of the Act and these regulations are being complied with by the AIF
- to inspect suo motu the affairs of an AIF, in the interest of the securities market or in the interest of investors.

SEBI shall give a 10-day notice to the AIF, before ordering such Inspection. However, in the interest of investors, if SEBI is satisfied that no such notice should be given, then it may by an order in writing direct that the inspection of the affairs of the AIF be taken up without such notice.

Sponsors and Managers, and all officers of the AIF are required to co-operate with SEBI and the Inspecting Authority. They should provide all required information for conducting inspection of records of the AIF with respect to activities of fund, and produce books, account and relevant documents to the Inspecting Authority.

After consideration of the Inspection Report, SEBI may issue such directions to the AIF as it deems fit in the interest of securities market or the investors including directions in the nature of:

- requiring an AIF not to launch new schemes or raise money from investors for a particular period.
- prohibiting the person concerned from disposing of any of the properties of the fund or scheme acquired in violation of SEBI AIF Regulations.
- requiring the person connected to dispose of the assets of the fund or scheme in a manner as may be specified by SEBI.
- requiring the person concerned to refund any money or the assets to the concerned investors along with the requisite interest or otherwise.
- prohibiting the person concerned from operating in the capital market or from accessing the capital market for a specified period.

14.12 Code of Conduct for AIFs

All AIFs shall abide by the following Code of Conduct specified in Fourth Schedule of the SEBI (Alternative Investment Funds) Regulations:

- a) Carry out its business activities and invest in accordance with the investment objectives stated in the placement memorandum and other fund documents.
- b) Be operated and managed in the interest of all investors and not only in the interest of the sponsor, manager, directors or partners of the sponsor and manager or a select class of investors.
- c) Ensure the dissemination of adequate, accurate, explicit and timely information in accordance with SEBI (AIF) Regulations, to all investors.
- d) Ensure the dissemination of any other information as agreed with the investors.
- e) Ensure that an effective risk management process and appropriate internal controls are in place.

- f) Have written policies and procedures to identify, monitor and appropriately mitigate any potential conflict of interest through-out the scope of its business.
- g) Not use any unethical means to sell, market or induce any investor to buy its units.
- h) Have written policies and procedures to comply with anti-money laundering laws.

SEBI has also prescribed Code of conduct for key management personnel of the fund, trustee, trustee company, directors of the trustee company, designated partners or directors of the fund, investment manager and key management personnel of the investment manager. The same has been discussed in Chapter 10 of this workbook.

14.13 Market Surveillance by AIFs

As per SEBI Master Circular No. SEBI/HO/ISD/ISD/CIR/P/2021/22 dt. March 01, 2021, all AIFs must ensure that:

- Proper internal code of conduct and controls should be put in place.
- Employees, temporary staff and voluntary workers should not encourage or circulate rumours or unverified information obtained from clients, industry, any trade or any other sources without verification.
- Access to Blogs/Chat forums/Messenger sites, should either be restricted under supervision or access should not be allowed.
- Logs for any usage of such Blogs/Chat forums/Messenger sites (called by any nomenclature) shall be treated as records and the same should be maintained as per SEBI AIF Regulations.
- Employees should be directed that any market related news received by them either in their official mail/personal mail/blog or in any other manner, should be forwarded only after the same has been seen and approved by the concerned Intermediary's Compliance Officer. If an employee fails to do so, he/she shall be liable for action and the Compliance Officer shall also be held liable for breach of duty in this regard.

14.14 Exemption from enforcement of the regulations in special cases¹⁸³

An AIF, a person or a class of persons may be exempt from the enforcement of any or all provisions of the SEBI (Alternative Investment Funds) Regulations, for a period not exceeding twelve months. This may be done for improving innovation, testing new products, processes, services or business models, in a live environment of regulatory sandbox in the securities

¹⁸³Inserted by SEBI (Regulatory Sandbox) (Amendment) Regulations, 2020 w.e.f. April 17, 2020 and amended by SEBI (Regulatory Sandbox) (Amendment) Regulations, 2021, w.e.f. August 3, 2021.

markets.¹⁸⁴ Such exemptions are subject to the applicant satisfying such conditions as may be specified by SEBI, including conditions to be complied with on a continuous basis.

14.15 Periodic Disclosures and Reporting

AIFs must ensure transparency and disclosure of information to investors on the following:

- Financial information, risk management, operational activities and portfolio investments
- Periodic disclosure on Fee structure for the Manager or Sponsor, and any fees charged by “associates” of the Manager or Sponsor
- Any inquiries or legal actions taken by legal or regulatory authorities
- Material liability, if any, arising during fund tenure
- Any material breach of provisions stated in the PPM or agreements made with investors or other fund documents
- Details of any change in control of the Sponsor, Manager or Investee Company
- Significant change in the key investment team shall be intimated to all investors
- AIFs shall provide information for systemic risk purpose, as required by SEBI, including risk identification, analysis and mitigation of systemic risk.
 - SEBI may call for any information from a registered III AIF, if required, for assessment of systemic risk or prevention of potential fraud. The AIF, Sponsor or Investment Manager shall furnish the same within the specified time limit.

The periodic disclosures and reporting requirements have been discussed in detail in Chapter 12 of this workbook.

14.16 Specific due diligence of investors and investments of AIFs

According to SEBI (AIF) Regulations, AIFs, Manager of AIFs and their Key Management Personnel (KMP) are required to carry out specific Due Diligence (DD), with respect to their investors and investments, to prevent facilitation of circumvention of laws specified by SEBI.¹⁸⁵

Specific DD is required to be conducted on the following entities and investments: (Refer Table 14.2)

- i. Investors of AIF who are availing benefits designated for QIBs through AIFs
- ii. Investors of AIF who are availing benefits designated for Qualified Buyers (QBs) through AIFs
- iii. RBI regulated lenders/entities evergreening their stressed loans/assets through AIFs

¹⁸⁴Regulatory sandbox means a live testing environment where new products, processes, services, business models, etc. may be deployed on a limited set of eligible customers for a specified period of time, for furthering innovation in the securities market, subject to such conditions as may be specified by SEBI.

¹⁸⁵SEBI Circular No.: SEBI/HO/AFD/AFD-POD-1/P/CIR/2024/135 dated October 8, 2024.

iv. Investment from countries sharing land border with India through AIFs

AIFs/ Managers/ KMPs are required to carry out DD for their existing investments as well as for any proposed investments. Upon carrying out the due-diligence checks for existing investments, if any of the existing investments do not satisfy the due diligence checks for making investment, details of such investments are to be reported to the custodian of the AIF. However, if all the existing investments of such schemes satisfy the respective due diligence checks for making investment, then manager of the AIF is required to submit an undertaking to the custodian. Custodians, in turn, will compile the information reported by AIFs and report to SEBI.

Table 14.2: Specific Due Diligence

Provisions of SEBI (Issue of Capital and Disclosure Requirements) Regulations, 2018 ('ICDR Regulations') and other SEBI regulations wherein benefits or relaxations have been provided to AIFs designated as Qualified Institutional Buyers (QIBs)

AIFs have been designated as QIBs under SEBI (ICDR) Regulations. To prevent AIFs from facilitating such investors, who are otherwise ineligible for QIB status on their own as per ICDR Regulations, the following should be done:

- i. Necessary due diligence as per the implementation standards formulated by the SFA to be carried out prior to availing QIB benefits under the ICDR Regulations, for every AIF Scheme wherein one investor, or investors belonging to a same group, contribute more than 50 percent of the corpus of the AIF Scheme.
- ii. If the proposed investments by the AIF Scheme are in accordance with the implementation standards formulated by the SFA, the manager shall proceed with the proposed investments. In case the proposed investments are not in accordance with the implementation standards, then either the investment shall not be made, or the investor/investor group mentioned above shall be excluded from the proposed investment, with necessary disclosures in the PPM for such exclusion of investor(s).

Provisions of Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002 (SARFAESI Act), wherein benefits are provided to entities designated as Qualified Buyers (QBs)

AIFs have been notified as Qualified Bidders (QBs) and are permitted to subscribe to Security Receipts (SRs) issued by an Asset Reconstruction Company (ARC). To prevent AIFs

from facilitating such investors, who are otherwise ineligible for QB status on their own as per SARFAESI Act, the following should be done:

- i. Necessary due diligence as per the implementation standards formulated by the SFA shall be carried out prior to making investments in SRs issued by an ARC, or availing benefits available to QBs under SARFAESI Act, for every AIF Scheme wherein one investor, or investors belonging to a same group, contribute more than 50 percent of the corpus of the AIF Scheme.
- ii. If the proposed investments by the AIF Scheme are in accordance with the implementation standards formulated by the SFA, the manager shall proceed with the proposed investments. In case the proposed investments are not in accordance with the implementation standards formulated by the SFA, then either the investment shall not be made, or the investor/investor group mentioned above shall be excluded from the proposed investment, with necessary disclosures in the PPM for such exclusion of investor(s).

Prudential norms specified by Reserve Bank of India (RBI) for regulated lenders with respect to Income Recognition, Asset Classification, Provisioning and restructuring of stressed assets

To address the issue of Evergreening of Stressed Loans/Assets of RBI regulated entities through the AIF Route, and to prevent circumvention of RBI Norms by such entities on Income Recognition, Asset Classification, Provisioning and Restructuring of stressed loans/assets, the following should be done:

- i. Necessary due diligence as per the implementation standards formulated by the SFA shall be carried out by every AIF scheme before making investments, whose:
 - Manager or sponsor is regulated by RBI, or
 - Investors are regulated by RBI:
 - who individually or along with a same group of investors, contribute more than 25 percent of the corpus of the AIF Scheme, or
 - who is an associate of the manager of sponsor of the AIF Scheme, or
 - who individually, or through representative(s)/nominees(s), has majority power or veto power in voting on decisions taken by the Investment Management Committee setup by the AIF Scheme
- ii. If an investor of the scheme is an AIF or a fund set up outside India or in International Financial Services Centres in India (GIFT City), then the criteria check for investor(s) regulated by RBI shall be carried out on a look through basis on the investors of such AIF or GIFT City fund.

- iii. If the proposed investments by the AIF Scheme are in accordance with the implementation standards formulated by the SFA, the manager shall proceed with the proposed investments. In case the proposed investments are not in accordance with the implementation standards formulated by the SFA, then either the investment shall not be made, or the investor/investor group mentioned above shall be excluded from the proposed investment, with necessary disclosures in the PPM for such exclusion of investor(s).

The AIF Manager of all the above-mentioned schemes, shall ensure that no investment is made which would lead to an RBI regulated entity acquiring an exposure in any investee company indirectly (that is, by means of investment in the AIF scheme), that the entity is not permitted to acquire or hold directly. A common example of such RBI regulated entities are Banks and Non-banking financial companies (NBFCs).

Rule 6 of Foreign Exchange Management (Non-Debt Instruments) Rules, 2019 (NDI Rules) for investment from countries sharing land border with India

As per Rule 6(a) of NDI Rules, a person resident outside India may subscribe, purchase or sell equity instruments of an Indian company subject to the terms and conditions and the manner specified in Schedule I of NDI Rules. However, an entity of a country which shares land border with India, shall invest only with the approval of the Government. Similarly, beneficial owners of such investment into India who is situated in or is a citizen of any such country, shall invest only with the approval of the Government. This applies to investors coming investing in India via. China, Pakistan, Bangladesh, Afghanistan, Nepal, Bhutan and Myanmar.

To ascertain whether investors from countries sharing land border with India are investing in Indian companies through AIFs, the following should be done:

- i. Necessary due diligence as per the implementation standards formulated by the SFA shall be carried out by every AIF scheme, before making the investment, if:
 - 50 percent of more of the corpus, is contributed by investors who are citizens of/are from/are situated in a country which shares land border with India, OR
 - 50 percent of more of the corpus, is contributed by investors whose beneficial owners are citizens of/are from/are situated in a country which shares land border with India, as determined by sub-rule (3) of Rule 9 of the Prevention of Money-laundering (Maintenance of Records) Rules, 2005.
- ii. Upon carrying out the necessary due diligence, the AIF scheme shall report details of its investment, which would result in the scheme holding 10 percent or more of

equity/equity-linked securities issued by an investee company (on a fully-diluted basis), to its custodian within 30 days of investment, in the format as may be specified by SFA. If the AIF Scheme holds 10 percent or more of equity/equity-linked securities issued by an investee company (on a fully-diluted basis), details of existing investments of the scheme shall be reported to the custodian, within prescribed timeline, in the format as may be specified by SFA.

B. Foreign Exchange Management Act, 1999

Foreign investment in India is primarily governed by the Foreign Exchange Management Act 1999 (FEMA) and the regulations framed thereunder, which consolidate the law relating to foreign exchange in India. On November 07, 2017, the Reserve Bank of India (RBI) had issued the Foreign Exchange Management (Transfer or Issue of Security by a Person Resident outside India) Regulations, 2017 (TISPRO Regulations), which stand superseded by the Foreign Exchange Management (Non-debt Instruments) Rules, 2019, notified by the Central Government and the Foreign Exchange Management (Debt Instruments) Regulations, 2019, notified by RBI. Pursuant to these amendments to FEMA, the Central Government, instead of the RBI, has been granted the power of specifying all permissible capital account transactions in non-debt instruments and the RBI has been granted the power of specifying all permissible capital account transactions in debt instruments.

The following instruments are now considered as ‘non-debt instruments’, inter alia, including:

- All investments in equity instruments of incorporated entities (whether public, private, listed and unlisted);
- Capital participation in limited liability partnerships (LLPs);
- All instruments of investment as recognized in the FDI Policy as notified from time to time;
- Investment in units of Alternative Investment Funds (AIFs), Real Estate Investment Trusts (“REITs”) and Infrastructure Investment Trusts (InvITs);
- Investment in units of Mutual Funds and Exchange-Traded Funds (ETFs) that invest more than 50 per cent in equity;
- The junior-most layer (i.e. equity tranche) of a securitization structure;
- Acquisition, sale or dealing directly in immovable property;
- Contribution to trusts;
- Depository receipts issued against equity instruments.

The following instruments are now considered as ‘debt instruments’, inter alia, including:

- Government bonds;
- Corporate bonds;
- All tranches of securitization structure which are not equity tranche;
- Borrowings by Indian firms through loans;
- Depository receipts whose underlying securities are debt securities.

14.17 FDI and its Economic Significance

It may be appreciated that India is a consumption-oriented economy and imports a large part of its oil requirements apart from gold, steel, several other commodities, capital goods, intermediate goods and consumption goods. As a result, for a long time, India has had an adverse balance of payment position in international trade i.e. imports are more than exports and the Current Account Deficit (CAD) was recorded at USD 1.30 billion or 0.20% of GDP for the fourth quarter of F.Y. 2022-23¹⁸⁶. Traditionally, due to the adverse CAD position, India had a shortage of free foreign exchange (internationally convertible foreign exchange). The Foreign Exchange Regulation Act introduced in 1947 was later replaced with the Foreign Exchange Regulation Act, 1973 (FERA), which came into effect on 1st Jan, 1974.

It was in 1991 that India faced a foreign exchange crisis and required a bail out from external resources. As a part of the bail-out conditions stipulated by the International Monetary Fund (IMF), the government initiated the process of liberalisation of Indian economy in 1991. The larger objective was to bring in a market-oriented economy and invite foreign capital into the country for long term investment. The requirement for foreign capital to finance India's economic investments is well-recognised from then on in government policy-making.

After the liberalisation of foreign investment policy in 1991, foreign direct investment or FDI was permitted in various sectors. Foreign investment is defined as "any investment made by a person resident outside India on a repatriable basis in capital instruments of an Indian company or to the capital of an LLP". 'Investment on repatriation basis' is an investment, the sale/ maturity proceeds of which are, net of taxes, eligible to be remitted outside India to the foreign beneficiary's account in fully convertible foreign exchange. In the later years, in order to curb the restrictive provisions of FERA, some of which were criminal provisions, the management of foreign exchange and serious economic offences relating to foreign exchange were separated. The administrative provisions of foreign exchange management were

¹⁸⁶ <https://www.livemint.com/news/india/indias-current-account-deficit-narrows-sharply-to-1-3-billion-in-q4fy23-as-trade-deficit-moderates-11687864523723.html>

enacted into a separate law called the Foreign Exchange Management Act (FEMA) 1999 and serious foreign exchange offences (including money laundering and round tripping) were included in the new Prevention of Money Laundering Act 2002 (PMLA). FEMA was made effective from 1st June, 2000. RBI introduced several liberalised regulations under the FEMA to ease investments by non-residents including NRIs.

Simultaneously, SEBI introduced foreign investment in capital markets and venture capital in India which are currently dealt with under separate policy regulations called Foreign Portfolio Investment (FPI) and Foreign Venture Capital Investors (FVCI) Regulations respectively. The introduction of FDI and FPI and subsequent liberalisations thereof increased flow of foreign exchange to India and foreign exchange reserves increased substantially in later years. Currently, India expects to gain substantially from liberalised FDI and NRI remittances to benefit its economy for investment in critical sectors like infrastructure, large manufacturing, exports, e-commerce, start-ups and services companies that are vital for its growth and development.

14.8 Investment Framework under FEMA¹⁸⁷

Investment framework under FEMA relates to regulating cross-border in-bound investments being made in India by non-resident investors and vice versa (foreign investment made by resident investors in India). It is necessary to appreciate that FEMA relies on the concept of ‘residence’ of an investor to differentiate between domestic and foreign investors and make regulations accordingly. The definition of ‘residence’ under FEMA need not correspond exactly with that under the Income Tax Act, 1961 in all cases. So investors need to check their residential status under both these laws separately to determine necessary compliance. The relevant regulations under FEMA governs the AIF investments by foreign investors including NRIs and PIOs, downstream FDI investments by AIFs in investee companies and AIF investments in overseas investment opportunities. These aspects are discussed in the following paragraphs.

14.18.1 NRIs and PIOs

Non-Resident Indian (NRI) means an individual resident outside India who is citizen of India and ‘Overseas Citizen of India’ means an individual resident outside India who is registered as an Overseas Citizen of India Cardholder within the meaning of section 7(A) of the Citizenship

¹⁸⁷ As amended or replaced from time to time

Act, 1955. The connotation of NRI under FEMA and the Income-tax Act, 1961 are different. The Income-tax Act, 1961 classifies NRIs under non-residents though under some provisions they are given differential treatment. 'Overseas Citizen of India' – OCI cardholders are deemed to be overseas citizens of India.¹⁸⁸ Thus, a person resident outside India will be 'NRI', if he is either a citizen of India or an OCI cardholder. For the purpose of FEMA, NRI means a person resident outside India who is a citizen of India.

Person of Indian Origin (PIO) means a citizen of any country other than Bangladesh or Pakistan, Afghanistan, China, Iran, Bhutan, Sri Lanka and Nepal, if:

- i) He or she at any time held Indian passport;
- ii) His or her parent(s) or any grandparent(s) or any great-grandparent(s) was a citizen of India by virtue of the Constitution of India or the Citizenship Act, 1955
- iii) The person is a spouse of an Indian citizen or a person

The definition has been modified for various purposes in various regulations. For the purpose of FEMA, a citizen of Bangladesh or Pakistan or Sri Lanka is excluded from the PIO definition.

14.18.2 Residence under FEMA

For the purpose of administration of FEMA, a distinction is made between 'resident' and 'non-resident' person. A person includes an individual, HUF, company, firm, an association of persons, body of individuals (whether incorporated or not), every artificial judicial person and any agency, office or branch owned or controlled by such person as per section 2(u) of FEMA.

A person resident in India would be one of the following categories under section 2(v) –

1. A person normally residing in India for more than 182 days during the course of preceding financial year. However, it does not include a person who has gone out of India or who stays outside India for employment outside India or carrying on business or vocation outside India or for any other purpose, in such circumstances as would indicate his intention to stay outside India for an uncertain period. Also, it does not include a person who has come to or stays in India, in either case, otherwise than to take up any employment or for carrying on any business or vocation or for any other purpose in such circumstances as his intention to stay in India for an uncertain period.
2. Any person or body corporate registered or incorporated in India.

¹⁸⁸ Registered as such under Notification No. 26011/4/98 F.I. dated 19.8.2002 issued by the Central Government.

3. An office, branch or agency in India owned or controlled by a person resident outside India.
4. An office, branch or agency outside India owned or controlled by a person resident in India.

It may be noted that under FEMA, the intention of stay is pertinent to prove residence but under the Income- tax Act, 1961, the physical stay is important to decide residence.

14.18.3 Investments by NRIs and PIOs

The Indian non-resident community constitutes an important source of foreign exchange for the Indian economy. India topped the list of nations with the highest inward remittances from its diaspora with a total remittance value of USD 89 billion in 2021-22.¹⁸⁹ NRIs and PIOs have been given some special preferences/ facilities for investment in India. These are in addition to foreign investment routes available to non-resident investors. As far as financial investments are concerned, NRIs have been provided the facility to invest in several investment options on a fully repatriable basis (i.e. they can invest and take back the capital and returns thereon in foreign exchange) and on a non-repatriable basis. Investment options include direct investments under the FDI route, government dated securities/ treasury bills, units of domestic mutual funds, bonds issued by a Public Sector Undertakings (PSUs) in India, shares in a PSUs (dis-invested by Government of India), shares and convertible debentures permitted to be invested under the FDI policy, shares and debentures of Indian companies, public deposits with Indian companies including Non-Banking Finance Companies (NBFCs), Housing Finance Corporations (HFCs) and other financial institutions and investments in investment vehicles such as AIFs registered with SEBI. Investments by NRIs / PIOs are regulated by the FDI policy read with the Master Directions and the Rules issued by RBI from time to time (these are explained in the following paragraph). NRIs along with other categories of non-residents such as PIOs and OCIs are allowed to invest in AIFs registered with SEBI under the FDI policy.

14.19 Inbound Foreign Investment Routes

Foreign investments in India can be classified under three different routes described below, apart from investment through the AIF route.

¹⁸⁹<https://pib.gov.in/PressReleasePage.aspx?PRID=1897036#:~:text=During%202021%2D22%2C%20India%20received,received%20in%20a%20single%20year>

1. **FDI Route** – All non-resident investments which are strategic in nature, i.e. for a business or long-term investment purpose make use of the Foreign Direct Investment (FDI) route. For the purpose of being classified as foreign direct investment, the size of the investment shall not be less than 10% of the post-investment fully diluted paid-up capital of the investee company. The FDI policy is issued from time to time by the DPIIT, Ministry of Commerce and Industry and Government of India. It is operationalised by the RBI under FEMA through the Foreign Exchange Management (Non- Debt Instrument) Rules ('NDI Rules') and the modalities and operational directions are issued under the FEMA Master Directions (both as amended from time to time).

The FDI policy read with the NDI Rules and Master Directions deals with prohibited sectors for FDI, permitted sectors with sectoral caps (i.e. the maximum FDI approved in the paid-up capital of an investee company in a given sector), type of securities that can be issued, investments that can be made under automatic route without prior permissions from RBI or the government, investments that require prior government and RBI approval, minimum capitalisation norms in select cases, pricing regulations for the issue of securities by Indian companies to non-resident investors, subsequent sale or transfer of such securities by non-residents and all incidental matters connected to foreign investments.

2. **FPI Route** – The Foreign Portfolio Investment (FPI) route is available to non-resident investors wherein the size of such investment shall not be more than 10% of the post-investment fully diluted paid-up capital of the listed Indian investee company. Such investments can be made in listed companies on the stock market or through private placements and other available routes. FPIs need to be registered with SEBI prior to commencing investment activity and such persons can be institutional or non-institutional investors. Such registration with SEBI shall be in accordance with the SEBI (Foreign Portfolio Investors) Regulations, 2019. The registration with SEBI will provide the necessary rules and regulations to be followed for FPI activity. In addition, the modalities for FPI investments under FEMA are covered in the Master Directions and the NDI Rules of RBI.
3. **FVCI Route** – The Foreign Venture Capital Investment (FVCI) route is available to off-shore funds that seek to make venture capital investments in eligible unlisted investee companies in India. FVCI funds need to be registered with SEBI prior to commencing investment activity under the SEBI (Foreign Venture Capital Investors) Regulations 2000. The registration with SEBI will provide the necessary rules and regulations to be followed for FVCI activity. In addition, the modalities for FVCI investments under FEMA

are covered in the Master Directions and NDI Rules of RBI. FVCIs are allowed to invest only in stipulated priority sectors such as bio-technology, infrastructure etc. except in the case of start-ups which can be from any sector.

An FVCI can also acquire units of a Category I AIF or any scheme therein. An FVCI may also invest in securities on a recognised stock exchange subject to the provisions of the SEBI (FVCI) Regulations, 2000. This includes receiving the proceeds of the liquidation of such schemes or funds. The pricing for such transactions relating to acquisition/ transfer securities/ instruments is not regulated and they can be at a price that is mutually acceptable to the buyer and the seller/ issuer.

14.20 Foreign Investments in AIFs

The NDI Rules, defines an ‘Investment Vehicle’ to mean an entity registered and regulated under relevant regulations framed by SEBI or any other authority designated for the purpose and shall include (i) Real Estate Investment Trusts governed by the SEBI (Real Estate Investment Trusts) Regulations, 2014, (ii) Infrastructure Investment Trusts governed by the SEBI (Infrastructure Investment Trusts) Regulations, 2014; and (iii) Alternative Investment Funds governed by the SEBI (Alternative Investment Funds) Regulations, 2012.

Further, the NDI Rules defines ‘unit’ to mean beneficial interest of an investor in the Investment Vehicle.

Foreign investors may make purchase or redemption of units issued by an Indian AIFs, either under the Automatic Route or under the Approval Route. The Automatic Route entails investing without the requirement of a prior approval from regulatory authorities such as the Department for Promotion of Industry and Internal Trade (DPIIT), RBI and other concerned departments of the Government of India. However, the Automatic Route is unavailable for investments in some sectors and for investments above established thresholds in some sectors. When the Automatic Route is unavailable, the foreign investor must obtain prior permission from the sector-specific competent authorities, known as the Approval Route. In case of doubt as to which competent authority is to be approached, the DPIIT is mandated to identify the competent authority concerned and hence, the DPIIT has established a Foreign Investment Facilitation Portal (FIFP).

A Foreign Investor investing in an AIF, having “Unified Structure” of investments, does not need to obtain prior approval from Government Authorities and can invest directly under the Automatic Route. Investment Managers of AIFs can set up foreign managers or funds under

the automatic route, subject to approvals from the financial services regulator in India as well as the regulator in the jurisdiction in which the investment is intended to be made.

All income earned by foreign investors by investing through the Automatic Route, including income based on dividends, interest and sales of units, must be routed through an authorized dealer before being repatriated back to the home country.

With effect from April 1, 2020, for an Indian company engaged in a sector where FDI is not prohibited, the default aggregate FPI limits is the applicable sectoral cap as laid out in Schedule I of the Foreign Exchange Management (Non-debt Instruments) Rules, 2019. A sectoral cap is the maximum limit of permissible investment by foreign investors, in one industry sector. As per the erstwhile TISPRO Regulations, these FPI limits were capped at 24 percent, with the investee company having an option to enhance the FPI limits to the applicable sectoral cap. In sectors where FDI is prohibited, the aggregate FPI limit is capped at 24 percent of the company's paid-up equity capital on a fully diluted basis. In case the FPI investor has breached the FPI ceiling limit, such investor will have 5 trading days, from the date of settlement of the trades, to divest its holdings in the company.

Rule 6 (c) of the NDI Rules, permits a person resident outside India, as defined above, to acquire, purchase, hold, sell or transfer units of an Investment Vehicle, in the manner and subject to the terms and conditions specified in Schedule VIII of the NDI Rules. A non-resident investor can also acquire units of the AIF against the swap of the equity instruments of the Special Purpose Vehicle (SPV) proposed to be acquired by the AIF.

The terms and conditions laid down under such Schedule VIII of the NDI Rules and the FEMA (Mode of Payment and Reporting of Non-debt Instruments) Regulations, 2019 are as under:

- The payment for acquisition of the units of the AIF is to be done by normal banking channel or out of funds held in Non-Resident External (NRE) account or Foreign Currency Non-Resident (B) (FCNR) account. The payment for the units of an AIF must be made by a debit to Foreign Currency Non Resident (FCNR) or Non-Resident External (NRE) or Special Non-Resident Rupee (SNRR) account maintained by a person resident outside India (the overseas buyer) with an Authorised Dealer or an Authorised Bank in India.¹⁹⁰
- An investor who has acquired or purchased units in accordance with NDI Rules may sell or transfer in any manner or redeem the units as per regulations framed by SEBI or directions issued by RBI.
- Downstream Investment is an investment made by an Indian Investment Vehicle in a domestic company, where more than 51 percent investors in the Indian Investment Vehicle are foreign investors. Ordinarily, such investments made by the Investment

¹⁹⁰ As per Foreign Exchange Management (Mode of Payment and Reporting of Non-Debt Instruments) Regulations, 2019.

Vehicle are considered to be “Indirect Foreign Investments” and are subject to the FDI restrictions therein.

- In order to boost foreign investments in India and in domestic AIFs, the RBI passed certain government reforms for easier investments in an AIF. As per RBI Notification No: FEMA 355/2015-RB dated November 16, 2015. Downstream investment by the AIF shall be regarded as indirect foreign investment for the investee Indian company if either the sponsor or the manager or the investment manager is not Indian owned or controlled. Provided that for sponsors or managers or investment managers organized in a form other than companies or LLPs, SEBI shall determine whether the sponsor or manager or investment manager is foreign owned and controlled. The RBI Notification allows a Foreign Investor to invest in an AIF and not comply with the FDI restrictions, if the Sponsor can justify that the “Control” of the fund is in the hands of either the sponsor or the investment manager. Ownership and control is determined as per the NDI Rules. AIF is a pooled investment vehicle. ‘Control’ of the AIF should be in the hands of ‘sponsors’ and ‘managers/ investment managers’, with the general exclusion to others. In case the ‘sponsors and ‘managers/ investment managers’ of the AIF are individuals, for the treatment of downstream investment by such AIF as domestic, ‘sponsors’ and ‘managers/ investment managers’ should be resident Indian citizens.
- The extent of foreign investment in the corpus of the Investment Vehicle will not be a factor to determine as to whether downstream investment of the Investment Vehicle is foreign investment or not.
- Downstream investment by an Investment Vehicle that is reckoned as foreign investment shall have to conform to the sectoral caps and conditions / restrictions, if any, as applicable to the company in which the downstream investment is made as per the FDI Policy and the NDI Rules.
- Any Indian entity or investment vehicle making downstream investment in another Indian entity shall be considered as indirect foreign investment and shall file Form DI with the RBI within 30 days from the date of allotment of the equity instruments.¹⁹¹
- An AIF which has received foreign investment, or made foreign investment abroad, in any previous year or the current financial year, shall file an annual return on the Foreign Liabilities and Assets (FLA), by 15th July of every year, using the Foreign Liabilities and Assets Information Reporting (FLAIR) portal launched by the Reserve Bank of India. Furthermore, an AIF with existing direct or indirect foreign investment is required to provide information to the RBI in the Single Master Form (SMF), through the Foreign Investment Reporting and Management System (FIRMS) portal. All Indian entities, including a AIFs, are mandatorily required to file the SMF from September 1, 2018. With

¹⁹¹ As per Foreign Exchange Management (Mode of Payment and Reporting of Non-Debt Instruments) Regulations, 2019

the new SMF manual and FIRMS framework, all filings will need to be completed by the AIFs, and verified, scrutinized and acknowledged or rejected by their respective Authorized Dealer (AD) Banks.

- An AIF which has issued its units to a person resident outside India should file InVi Form, within 30 days from the date of issuance of units. The following information has to be provided in the form:
 - Name of the investor
 - Jurisdiction of the Investor
 - Type of Investor (FPI, NRI, FVCI, Individual, Company, Others)
 - Amount of Foreign Investment
 - Date of receipt of Foreign Investment
 - Number of units issued
 - Date of issuance of units

14.21 Overseas Investments by AIFs

Under Regulation 15(1)(a) of SEBI (AIF) Regulations, an alternative investment fund may invest in securities of companies incorporated outside India subject to such conditions or guidelines that may be stipulated or issued by the RBI and SEBI from time to time. In this regard, the RBI has permitted an AIF, registered with SEBI, to invest overseas in terms of its regulations.¹⁹²

SEBI issued detailed guidelines on overseas investments by an AIF, the highlights of which are presented below:¹⁹³

1. AIFs may invest in equity and equity linked instruments only of offshore venture capital undertakings which are not listed on a recognised stock exchange in India or abroad, subject to overall limit of USD 1500 million for all AIFs to be allocated on a first-come-first-served basis.¹⁹⁴
2. AIFs desirous of making investments in offshore venture capital undertakings shall submit their proposal for investment to SEBI for prior approval. It is clarified that no separate permission from RBI is necessary in this regard. The approval is valid for 6 months to complete all the investments under the sanctioned limit failing which, it shall lapse. In case the applicant does not utilise the limits allocated within the

¹⁹²A.P.(DIR Series) Circulars No.48, 49 and 50 dated December 09, 2014, April 30, 2007 and May 4, 2007 respectively.

¹⁹³ SEBI Circular CIR/IMD/DF/7/2015 dated October 1, 2015 on Guidelines on overseas investments and other issues/ clarifications for AIFs/ VCFs.

¹⁹⁴ Enhanced limit from USD 750 million by notification vide SEBI Circular No.: SEBI/HO/IMD/DF6/CIR/P/2021/565 dated May 21, 2021. Not applicable to Category I AIF/Category II AIF domiciled in IFSC.

stipulated period, SEBI may allocate such unutilised limit to other applicants. Investments shall also be subject to NDI Rules.

3. Such investments shall not exceed 25% of the investable funds (capital) of the scheme of the AIF.
4. The AIF shall report the utilization of such overseas investment limits within 5 working days. The fund should also inform SEBI if such investment limits was unused or partially used in a financial year or if the Fund wishes to stop making overseas investments.
5. Investments would be made only in those companies which have an Indian connection (e.g. company which has a front office overseas, while back office operations are in India).
6. AIFs shall not invest in Joint Venture or Wholly Owned Subsidiary of itself while making overseas investments.
7. AIFs shall comply with all the requirements under RBI guidelines on opening of branches/subsidiaries/Joint Venture /undertaking investment abroad by NBFCs, where more than 50% of the funds of the AIF has been contributed by a single NBFC.

C. Prevention of Anti-Money Laundering Act, 2002

India is a full-fledged member of the Financial Action Task Force (FATF), an international watchdog for money laundering. Member nations are required to pass domestic laws to prevent money laundering and perform an oversight function. In pursuance of international commitments, the Prevention of Money Laundering Act (PMLA) was enacted to prevent the generation of black money and proceeds from criminal activities. PMLA states that whosoever directly or indirectly attempts to indulge, or knowingly assists, or knowingly is a party, or is actually involved in any process or activity connected to proceeds of crime, including its concealment, possession, acquisition or use, and projecting or claiming it as untainted property shall be guilty of the offence of money-laundering. In other words, money laundering is the process of conversion of money obtained from criminal activity into apparently legitimate money by concealing its criminal origin. The main objective of the Prevention of Anti-Money Laundering Act (PMLA) is, therefore, to prevent and control activities concerning money laundering and to confiscate property derived from or involved in money laundering.

Generation of black money through cash transactions and funnelling it into bank accounts, through layering with a series of fictitious transactions using shell companies, is a very good example of money laundering in the domestic economy. Money laundering through cross border route is also possible through the process of round tripping, 'hawala' transactions, etc., and routing the funds through bank accounts in tax havens, held by private trusts and other concealed entities. Money laundering is a serious economic offence as it undermines the integrity of the market participants, distorts economic performance, mis-allocates capital flows, evades taxes and finances criminal and terrorist activities.

14.22 Regulatory Oversight

The PMLA requires the reporting entities i.e. banks, financial institutions and intermediaries, such as AIFs to maintain records of the following transactions:

- All cash transactions of the value of more than INR 10 lakh, or its equivalent in foreign currency
- All series of cash transactions, integrally connected to each other and individually valued below INR 10 lakh, or its equivalent in foreign currency, but have taken place within a month and the monthly aggregate exceeds the threshold of INR 10 lakh or equivalent in foreign currency.
- All transactions involving receipts by a non-profit organization (NPO) of value more than INR 10 lakh or its equivalent in foreign currency.
- All cross-border wire transfers of a value of more than INR 5 lakh or its equivalent in foreign currency, where either the origin or destination of fund is in India
- All cash transactions where forged or counterfeit currency notes or bank notes are used as genuine notes.
- All suspicious transactions whether or not made in cash and including, inter-alia, credits or debits into from any non-monetary account such as demat accounts, etc.

The transactions must be recorded in such manner as to enable the relevant institution to reconstruct individual transactions.

Financial institutions, including AIFs, must perform client due diligence as per the Prevention of Money Laundering (Maintenance of Records) Rules.

The AIF must, at the time of commencement of the client-relationship:

- verify and maintain the records of identity of their clients
- obtain information on the purpose and intended nature of the business relationship
- determine whether a client is acting on behalf of a beneficial owner and thereby identify and verify the identity of such beneficial owner, if any.

Every AIF has to be registered with Central KYC Records (CKYCR) Registry, by filing an application with requisite documents and details of the Sponsors, Investment Manager, Compliance Officer, two authorised administrative staffs for online filing of documents and performing maker-checker control.

The AIF should upload the KYC information of customers, in the KYC template provided on CKYCR portal along with scanned copy of Proof of Address (PoA) and Proof of Identity (PoI) after successful verification. After uploading such information, the KYC Identifier issued by the CKYCR portal must be communicated to the respective investors. If a new investor has an existing KYC Identifier, the AIF should download the KYC information from the CKYCR portal and use such information only for the purpose of identity verification. In case of any

change in the KYC information of its investors, the AIF must update the same on the CKYCR portal.

An AIF is required to file the electronic copy of the client's KYC records with the Central KYC Records Registry within 10 days after the commencement of relationship with a client.

If the AIF has Foreign Portfolio Investors (FPIs), the fund should adopt the risk-based KYC framework, applicable to such investors. The AIF should upload the KYC documents on the KYC Registration Agency (KRA) portal for other market intermediaries or funds to access and complete their KYC requirements. Identification of Ultimate Beneficial Owners (UBOs) is imperative for the fund, to establish the natural person who ultimately owns or controls the institution which is investing in the AIF. The Ultimate Beneficial Owners, structured as a company or a trust, should be identified on controlling ownership interest (also termed as 'ownership or entitlement') and control basis, which is 25percent as per the PMLA Rules. The Ultimate Beneficial Owners, structured as a partnership firm or an unincorporated association of individuals, should be identified on ownership or entitlement basis, which is 15 percent as per the PMLA Rules.

Custodians should maintain the KYC records in original for a minimum period of 5 years from the date of cessation of the transactions with the FPIs investing in the AIF. In case any litigation is pending, these records should be maintained till the completion of the proceedings.

Further, an AIF must ensure that appropriate steps are taken to recognize and report suspicious transactions to the Director – Financial Intelligence Unit (FIU) - India.¹⁹⁵ An illustrative list of suspicious transactions is given below:

- Clients whose identity verification seems difficult or clients that appear not to cooperate
- Asset management services for clients where the source of the funds is not clear or not in keeping with clients' apparent standing /business activity;
- Clients based in high risk jurisdictions;
- Substantial increases in business without apparent cause;
- Clients transferring large sums of money to or from overseas locations with instructions for payment in cash
- Attempted transfer of investment proceeds to apparently unrelated third parties;
- Unusual transactions by businesses undertaken by offshore banks/financial services, businesses reported to be in the nature of export-import of small items.

To ensure compliance, monitoring and report compliance of Anti Money Laundering, all AIFs must appoint a Principal Officer (PO), who shall be responsible to monitor and report transactions and share information on Anti Money Laundering as required under the law.

¹⁹⁵ Vide SEBI Master Circular No.: SEBI/HO/MIRSD/DOP/CIR/P/2019/113 dated October 15, 2019 on Guidelines on Anti Money Laundering (AML) Standards and Combating the Financing of Terrorism (CFT)/ Obligation of Securities Market Intermediaries under the Prevention of Money Laundering Act, 2002 and Rules framed thereunder.

The Principal Officer shall maintain close liaison with enforcement agencies, brokers and any other institutions that are involved in the fight against money laundering and combating financing of terrorism. The Principal Officer shall furnish a compliance certificate to the Board on regular basis certifying that Revised Anti Money laundering Policy is being strictly followed, consisting reference of alerts so generated, if any, STRs, if any so made during that period.

Any suspicious transaction shall be immediately notified to the Money Laundering Control Officer or a designated officer with the AIF. AIFs are also directed to take counter measures against clients based in high risk jurisdictions, including countries where existence and effectiveness of money laundering controls is suspected or which do not or insufficiently apply FATF standards. These measures may include a further enhanced scrutiny of transactions, enhanced and systematic reporting mechanisms for financial transactions and applying enhanced due diligence while expanding business relationships with such clients.

Some AIFs may receive capital commitments from family trusts, foundations or trusts and entities which may be formed as a society under the Societies Registration Act, 1860 or a company registered under section 8 of the Companies Act, 2013. Such transactions have to be reported and KYC has to be done on the non-profit organisations (NPOs), as discussed above. Further, family trusts are not required to be registered under the Registration Act. Such a family trust would not be regarded as a registered trust and, hence, not fall within the definition of NPO, under PMLA Rules. A family trust on the other hand is set up with the objective of maintenance and creation of wealth for the ultimate benefit of beneficiaries of the family creating such trust. Therefore, investments received by an AIF, from a family trust, would not be covered under the PMLA Rules pertaining to transactions undertaken by NPOs, and as such are not required to be reported, unless they get covered in any other category such as suspicious transactions.

The Director-FIU, India has been permitted to make provisional attachment of property for a period not exceeding 180 days if there is reason to believe that the person is in possession of any proceeds of crime. The Finance Act 2015 introduced certain amendments to the PMLA and expanded the definition of 'proceeds of crime' to include those which are taken out of the country as well.

D. Other related SEBI Regulations

14.23 SEBI (Issue of Capital and Disclosure Requirements) Regulations, 2018

Preferential allotment of securities by listed companies needs to comply with the SEBI (Issue of Capital and Disclosure Requirements) Regulations, 2018 (ICDR Regulations) and Securities Contract (Regulation) Act, 1956 in addition to the Companies Act, 2013.

The ICDR Regulations regulate issuances of shares as part of an Initial Public Offer (IPO) by unlisted companies or further public offers (FPOs), rights issues or preferential allotments by listed companies. In addition, SEBI stringently regulates all offers for sale, further

issuances and rights issues by listed companies, except when the value of such shares does not exceed INR 10 crore. ICDR Regulations have different impacts for an AIF looking to make an investment in a company through an IPO, or exit from an investee company through an IPO.

- **Pricing of securities issued in IPO:**

An unlisted company that is eligible to issue shares or stock may freely price its shares or any securities convertible at a later date into equity shares as part of its IPO.

- **Lock-in restriction in case of securities issued in IPO:**

The ICDR Regulations require timely disclosure of the aggregate shareholding of the promoter's group as well as the details of "inter-se" transfer of securities amongst the promoters. A promoter or promoter group shall have a minimum shareholding of 20 percent in the company. Such contribution is locked-in from the date of allotment in the proposed public issue and cannot be disposed-off until 18 months from the date of allotment of shares. In case the IPO involves fresh issue of equity shares and the majority of the proceeds from such fresh issue are proposed to be utilised for capital expenditure, then the lock-in period for minimum promoter contribution shall be 3 years.¹⁹⁶ However, inter-se transfer of promoter holdings is possible as long as the lock-in on such securities shall continue for the remaining period with the transferee and such transferee shall not be eligible to transfer the securities till the lock-in period of 3 years has expired.¹⁹⁷ An AIF is not deemed to be a promoter or to form part of the promoter group, only by virtue of their equity holding of 20 percent in the company, unless it satisfies other requirements prescribed in ICDR Regulations.

Further, the entire pre-issue share capital of an unlisted company (other than the minimum promoter contribution) is locked in for a period of 6 months from the date of allotment in the public issue. In case the IPO involves fresh issue of equity shares and the majority of the proceeds from such fresh issue are proposed to be utilised for capital expenditure, then the lock-in period for such shares shall be 1 year. A Category II AIF or a Category III AIF holding shares in the unlisted company, will be subject to this 6-month lock-in period or the 1 year lock-in period, as the case may be, from the date of the allotment of shares.

As per Regulations 29(1) of SEBI (Substantial Acquisition of Shares and Takeovers) Regulations, 2011 (Takeover Regulations), all AIFs must disclose their aggregate shareholding and voting in the investee company if acquisition of shares or voting rights aggregates to five per cent or more of the shares of such target company. The disclosures should be made within two working days of the receipt of intimation of allotment of shares, by the AIF.

¹⁹⁶ As per Securities and Exchange Board of India (Issue of Capital and Disclosure Requirements) (Third Amendment) Regulations, 2021.

¹⁹⁷ Regulation 22 of the SEBI (Issue of Capital and Disclosure Requirements) Regulations, 2018.

- **Preferential Allotment of Shares in a QIP:**

An AIF may invest by participating in a private placement of securities by the issuer or in a Qualified Institutions Placement (“QIP”). Through a QIP, a listed company can make preferential issue of securities to Qualified Institutional Buyers (“QIBs”) on a private placement basis. Qualified institutional Buyers include sophisticated investors such as Mutual Funds, Alternative Investment Funds, Commercial Banks and other Financial Institutions.

- **Lock-in Restriction in case of Preferential Allotment:**

Securities issued to investors such as AIFs, in a preferential allotment shall be subject to a lock-in for a period 6 months from the date of allotment of shares. In case the IPO majority of the proceeds from such preferential allotment are proposed to be utilised for capital expenditure, then the lock-in period for such shares shall be 1 year.

- **Sale of Shares in an Offer for Sale (OFS):**

Existing shareholders are permitted to exit from companies through an “offer for sale” of their holdings to the public, after receiving necessary approvals from the board, shareholders and the stock exchanges. As per the ICDR Regulations, only those equity shares which are held by the “Offeror”, or seller, for a period of at least 6 months at the time of filing the draft offer document with the SEBI can be offered to the public through an “offer for sale.” In case of an Offer for Sale of equity shares, where the majority of the proceeds from such fresh issue is proposed to be utilised for capital expenditure, then the lock-in period for such shares shall be 1 year¹⁹⁸. Hence, an AIF must ensure that their exit strategy from an investee company takes into consideration various lock-in conditions. An AIF having an intention to sell shares in an OFS is permitted to give notice of its intention to sell the shares latest by 5 pm on T-1 day, T being the day of the OFS.

SEBI made it mandatory for the offeror, i.e. the AIF, to give an option to retail investors to place their bid at a cut-off price, in addition to placing price bids for securities. Cut-off price shall be determined based on the bids received on T-day. On T-day, only non-retail investors shall be permitted to place their bids, whereas retail investors shall bid on T + 1 day. Retail investors may place a price bid or opt for bidding at cut off price.

14.24 Foreign Account Tax Compliance Act and Common Reporting Standard

Foreign Account Tax Compliance Act (FATCA) was introduced by the United States Internal Revenue Services (IRS), to address concerns about revenue loss arising from offshore tax abuse, by U.S. citizens. High Net-worth Individuals and Institutional Investors, registered in the United States sourced income from non-US Offshore accounts, which were not declared in their respective income tax filings.

¹⁹⁸As per Securities and Exchange Board of India (Issue of Capital and Disclosure Requirements) (Third Amendment) Regulations, 2021.

Indian Government signed an Inter-Government Agreement (IGA) under the FATCA, on July 09 2015 and effective from August 31 2015, under which the Central Board of Direct Taxes (CBDT) in India has agreed to exchange financial information with the Internal Revenue Services (IRS) of United States. Information is to be exchanged with the primary objective of tracking U.S. citizens and U.S. Institutions with financial accounts held in Indian financial institutions.

Although the FATCA law aims to obtain information on U.S. persons, the Fund may in furtherance of its FATCA obligations, require prospective investors to provide any information, tax documentation and waivers that the Fund determines are necessary to comply with FATCA, the agreement and rules or guidance notes implementing the agreement. The Fund's ability to satisfy such reporting obligations will depend on each prospective investor providing, or causing to be provided, any information, tax documentation and waivers including information concerning the direct or indirect owners of such investors that the Fund determines are necessary.

The Organization for Economic Co-operation and Development (OECD) has also implemented a similar reporting framework for automatic exchange of information within member countries, on relevant financial data for prevention of offshore tax abuse. This reporting framework is known as **Common Reporting Standard** (CRS) and India is a signatory to exchange information under the CRS, from June 3, 2015.

For effective implementation and exchange of information as per requirements of FATCA and CRS, the Income Tax Act, 1961 was amended to notify rules 114F to 114H under the Income Tax Rules, 1962 and the CBDT issued guidance notes for FATCA and CRS compliance and implementation.

As per the FATCA and CRS compliance requirements, every entity is required to ascertain its status, whether as a Financial Institution or a Non-Financial Entity (NFE). If an entity is a financial institution, it should be examined as to whether such an institution constitutes a reporting financial institution (RFI) or a non-reporting financial institution. A non-reporting financial institution is not required to register with the IRS and report financial accounts. A Reporting Financial Institution (RFI) is an Indian Financial Institution which agrees to obtain and exchange information, under the provisions of the Inter-Government Agreement between India and the United States.

As per the provisions of FATCA and CRS, financial institutions including Alternative Investment Funds have been given additional due diligence requirements related to investor accounts, under Rules 114F to 114H of the Income Tax Rules, 1962. AIFs should register with the US IRS and obtain a Global Intermediary Identification Number (GIIN) and also register with the Indian Income Tax authorities for reporting personal tax and beneficial owner information of all investors, self-declarations, and documentation received from all investors, such as:

- Name
- Address

- Place (city/state) of birth
- Country of birth
- Nationality
- Gross Annual Income
- Occupation
- Permanent Account Number (PAN)
- Whether the resident of another country? If yes, then the country of residence and Tax Identification Number (TIN)
- Social Security Number (SSN), if applicable

From January 2016, it is mandatory for all Indian and NRI investors in an AIF to file a FATCA self-declaration. FATCA reporting would be required for investors identified as 'U.S. persons', while CRS reporting is required for foreign investors from other countries in the world, investing in the AIF.

If the Fund has U.S. Investors or beneficial ownership of a U.S. registered entity, information will have to be reported by the AIF to tax authorities. An AIF is a deemed financial institution and hence the investors will be required to comply with the information request of the Fund to furnish any information, documents or declarations, as and when deemed necessary. In case any investor fails to furnish such information sought, the fund reserves the right to reject the application or redeem the existing units of the concerned investor, in addition to reporting the investor to the regulatory authority.

FATCA and CRS provisions are relevant not only at on-boarding stage of the investors but also throughout the life-cycle of investment with the Fund. Investors therefore should intimate to the Fund or the Investment Manager, any change in the FATCA and CRS related information submitted previously, within thirty days from the date of knowledge of such change. The onus to provide accurate, adequate and timely inputs in this regard would be on the concerned investor.

Sample Questions: Chapter 14

1. The following investors are not an accredited investor, as per the Accreditation Framework:
 - a. An individual investor having annual income of INR 5 crore
 - b. An corporate having networth of INR 250 crore
 - c. **An individual investor having annual income of INR 50 lakh**
 - d. An individual investor having networth of Rs 50 crore.
2. Which of the following entity is least likely to be a permissible legal structure, seeking registration as an AIF under the SEBI (Alternative Investment Funds) Regulations?
 - a. Limited Liability Partnership (LLP)
 - b. Company
 - c. Trust
 - d. **Proprietorship**
3. For an Indian company engaged in a sector where FDI is not prohibited, the default aggregate FPI limits is the applicable sectoral cap as laid out in Schedule I of the Foreign Exchange Management (Non-debt Instruments) Rules, 2019. State whether True or False.
 - a. **True**
 - b. False
4. AIFs can invest in Joint Venture or Wholly Owned Subsidiary of itself while making overseas investments. State whether True or False.
 - a. True
 - b. **False**
5. The PPM should be submitted by the AIF sponsor through a SEBI-registered Custodian. State whether True or False.
 - a. True
 - b. **False**

GLOSSARY

A round

Successive rounds of funding for a Venture company are given successive letters, i.e. the A round will come first, followed by the B round, etc. New Venture Capital investors can be introduced in each round. An A round is usually defined as the first round in which a professional Venture investor participates, but this is misleading as this could equally refer to a seed round, depending on the stage in a company's development at which it takes place. An A round may be preceded by one or more angel rounds as well as by a seed round.

A shares

Different classes of share are customarily created for different funding rounds in a Venture company. Traditionally, A shares are issued for the A round, B shares for the B round, and so on.

Angel

Someone who invests in Venture companies, typically at a very early stage, but is not a professional Venture Capitalist.

Anti Dilution

Provisions commonly found in the funding agreements governing rounds of investment in Venture companies under which the shareholdings of certain shareholders (typically early - stage investors and entrepreneurs) cannot fall below a specified percentage of the whole.

Bottom up

The way in which analysis of Private Equity funds must be carried out, by modelling the individual transactions within a fund in order to build up a picture of the whole.

Buyout

Generic name for a group of transactions in which debt is used to assist the acquisition of a control position in a company. One of the two main categories of Private Equity, the other being Venture Capital.

Capital Call

A demand by a Private Equity fund for some part of the money which has been committed (i.e. promised) to it by investors. Each such demand, and the payment made pursuant to it, is called a drawdown.

Carried interest or Carry

That share of the profits made by a Private Equity fund which is reserved for the management team.

Catch - up

Where a hurdle rate applies, a procedure under which all of the gains of a fund can be applied to the Investment Manager once the hurdle rate is achieved until the underlying carry percentage is reached.

Class rights

Rights (such as a liquidation preference) attaching to a particular class of shares in a company which cannot be varied except with the consent of the holders of that class of share.

Clawback

An arrangement whereby at the end of a fund's life, the investors may recover from the Manager of the fund any overpayment of carry (i.e. where full account has not been taken of loss - making deals).

Commitment

A legally binding promise by an investor to make a certain amount of money available to an Alternative Investment Fund on demand.

Committed capital

When used by an investor, the total of all current commitments to all funds by that investor. When used by a fund, the total amount of capital currently committed to that fund by all investors.

Distributed to paid in (DPI)

A multiple commonly used in analysing Private Equity funds. It represents the ratio of money distributed (i.e. paid out) by the fund to money paid in (i.e. drawn down). This ratio is referred to as the realisation ratio, but is only really meaningful in the very late stages of a fund's lifetime.

Distribution

The process of a fund paying money to an investor after exiting an investment. This can sometimes take the form of an in-specie distribution of shares.

Drag Along

A form of exit protection whereby shareholder A can force shareholder B to sell B's shares alongside A's should A receive an offer from a third party.

Drawn down capital

When used by an investor, the total amount of committed capital which has actually been requested by the funds. When used by a fund, the total amount of committed capital which it has actually drawn down from its investors. In either case, drawn down capital is the same thing as paid - in capital.

Dry Powder

Amount of committed but unallocated capital with VC and PE firms for deployment when attractive investment opportunity arises, or to ease financial distress.

Due diligence

The process of performing background checks and rigorous financial analysis on a fund (for an investor) or on a potential investee company (for a manager of the fund). Since due diligence is a lengthy and costly exercise, it will normally only be entered into once a decision to invest in principle (i.e. 'subject to due diligence') has been taken.

Exit protection

Contractual provisions within a shareholders' agreement which seek to protect the right of the Private Equity investor to force an exit, usually after the expiry of a set period. For example, Drag Along and Tag Along.

Fund cycle

The natural rhythm of a fund's operations. Very broadly, this will usually take the form of an investment period, followed by a development period and a harvesting period, when exits are effected.

Fundraising

The process of finding investors (LPs) to commit to a new fund.

Hedge Fund

Private investment pools that invest aggressively in all types of markets, with managers of the fund receiving a percentage of the investment profits.

Hurdle or Hurdle rate

Used in its commonly accepted sense of a hurdle return, i.e. the lowest possible return which a particular investor will accept. However, also used specifically to describe a return which an Investment Manager has to at least equal before any carry is calculated or payable.

In specie

A Latin phrase meaning literally 'in its actual form'.

Invested capital

The total amount of drawn down capital which has actually been invested in companies. In practice, this will be equal to the amount of drawn down capital less amounts which have been used to pay fees, or which are awaiting investment.

Investee company

A company within a Venture Capital fund/ Private Equity fund, i.e. an entity in which the fund buys shares, and/or to which it provides finance in some form of convertible instrument.

IRR

Internal rate of return (so called because it was originally used to calculate the return on different projects within a company). The compound return of a series of cash flows over a specified period (usually several years), used as one of the two main measures of Private Equity returns. The strict business school definition is that compound return, found by iteration, which will reduce the NPV of any stream of cash flows to zero.

J - curve

The effect of all Private Equity funds, irrespective of final performance, exhibiting strongly negative returns in the early years as money is drawn down into the fund, reversing as distributions begin to be made. So called from the shape made by the returns when plotted on a cumulative compound basis.

LBO

Leveraged Buyout. In one sense all Buyouts are LBOs, since they all involve the use of debt. However, this now has two main connotations: (1) a very large transaction, frequently with multiple business activities and (2) a transaction which is not initiated by a management team. It may be convenient to think of it as an industrial acquisition where the acquirer just happens to be a Buyout firm (or consortium).

MBI

Management Buy - In. A type of Buyout transaction where a group of experienced executives buy not their own business but one which is operating in the same sector.

MBO

Management Buyout. A type of Buyout transaction in which the team of executives managing a business buy it out from the parent company with the support of a Buyout firm.

Mezzanine

Convertible unsecured debt which sits between the equity and senior debt layers of a Buyout structure.

Post money

Refers to a valuation of a Venture company including the amount of money contributed by the Venture round in question.

Pre money

Refers to a valuation of a Venture company before taking into account the amount of money contributed by the Venture round in question.

Seed round

A round of Venture funding which takes place during the seed stage. May be preceded by an angel round, but in this case it risks being defined as an A round instead, unless it occurs fairly soon after the seed round.

Senior debt

Strictly, debt which takes priority over other layers of debt in the Buyout structure, both as to repayment and on liquidation.

Skin in the game

The existence of a significant financial contribution and commitment to the fund by the sponsors and managers.

Tag Along

A form of exit protection, whereby shareholder A can force shareholder B to sell A's shares alongside B's should B receive an offer from a third party.

Time - weighted (returns)

A most misleading term as it actually means the exact opposite of what it suggests. Instead of calculating the actual IRR of a series of cash flows over a given period (i.e. the compound return over time), time - weighted returns calculate the geometric mean, i.e. the average of the annual percentage return in any one year.

Venture Debt

Type of debt financing for early-stage companies; complementary to equity financing for raising capital.

Vintage year

The year in which a fund, or group of funds, was formed.

Glossary compiled from various references/sources:

1. Private Equity as an Asset class by Guy Fraser – Sampson
2. Bain & Company India Venture Capital Report 2023
3. Glossary of Capital Markets by SEBI

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