NISM CERTIFICATION EXAMINATION WORK BOOK

XIX-B

Alternative Investment Funds (Category III) Distributors

NiSM
NATIONAL INSTITUTE OF SECURITIES MARKETS
An Educational Initiative of SEBI

Workbook for

NISM-Series-XIX-B: Alternative Investment Funds (Category III) Distributors

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 Alternative Investment Funds (Category III) Distributors.

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National Institute of Securities Markets

NISM Bhavan, Plot 82, Sector 17, Vashi

Navi Mumbai – 400 703, India

National Institute of Securities Markets

Patalganga Campus

Plot IS-1 & IS-2, Patalganga Industrial Area

Village Mohopada (Wasambe)

Taluka-Khalapur

District Raigad-410222

Website: www.nism.ac.in

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FOREWORD

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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. The book covers basic understanding of the alternative asset classes, alternative investment funds in India, role and functions of various stakeholders in AIF ecosystem (such as Sponsor, Investment Management Company, Distributors, Investors). The book also discusses, in depth, about the Category III AIFs, its suitability and related regulations. The book also provides an understanding of the valuation techniques, investment strategies, and performance evaluation along with benchmarking policies adopted by AIFs. It further discusses about the taxation aspects and the good practices to be followed by the distributors servicing the Category III AIFs market in India.

Dr. CKG Nair

Director

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Acknowledgement

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NISM gratefully acknowledges the contribution of the Examination Committee of NISM-Series-XIX-B: Alternative Investment Funds (Category III) Distributors Certification Examination consisting of industry experts and the support of Indian Private Equity and Venture Capital Association (IVCA).

About NISM Certifications

The School for Certification of Intermediaries (SCI) at NISM is engaged in developing and administering Certification Examinations and Continuing Professional Education (CPE) Programs for professionals employed in various segments of the Indian securities markets. These Certifications and CPE Programs 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. The School for Certification of Intermediaries (SCI) seeks to ensure that market intermediaries meet defined minimum common benchmark of required functional knowledge through Certification Examinations and CPE Programs on Mutual Funds, Equities, Derivatives, Securities Operations, Compliance, Research Analysis, Investment Advice and many more.

Certification creates quality market professionals and catalyzes greater investor participation in the markets. Certification also provides structured career paths to students and job aspirants in the securities markets.

About the Certification Examination for Alternative Investment Funds (Category III) Distributors

The examination seeks to create a common minimum knowledge benchmark for persons working as Distributors or Placement Agents in Alternative Investment Fund domain in India and aims to enhance the quality of sales and distribution and enable better quality investor services. The examination focuses on Category III AIFs. NISM-Series-XIX-B is a voluntary examination.

Examination Objectives

On successful completion of the examination the candidate should:

- Know the basics of alternative asset class and the Alternative Investment Funds (Category III) markets in India.
- Understand the following in detail pertaining to Category III AIF:
    - Ecosystem of AIF (Category III) and role of its external service providers
    - Role of Category III AIFs as a Risk Management Tool
    - Fund structure, fee structure, performance measurement techniques and its interpretations, importance and role of performance benchmarking
    - Various investment strategies involved and investment due diligence process followed by investors
    - Concept of NAV, valuation techniques used and role of third-party registered valuers
    - Various taxation aspects for the fund and its investors, in both domestic and IFSC jurisdictions
    - Role and conduct of distributors in servicing the investors
- Know the regulatory environment in which the AIFs (Category III) operate in India.

Assessment Structure

The examination consists of 80 multiple choice questions and 5 case-based questions (each case having 4 questions). The assessment structure is as follows:

Multiple Choice Questions [80 questions of 1 mark each]	80*1 = 80
Case-based Questions [5 cases (each case with 4 questions of 1 mark each)]	5*4*1 = 20

The examination should be completed in 2 hours. The passing score for the examination is 60. 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 1 – Overview of Alternative Investments

LEARNING OBJECTIVES:
After studying this chapter, you should know about: • Difference between Traditional investments and Alternative investments • Different avenues of alternative investments such as venture capital, private equity, real estate etc. • Global evolution and growth of alternative investments • Role of alternative investment funds in portfolio management

1.1 Introduction to 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.[2] 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. Alternative investments are meant to complement traditional investments for such investors by improving their risk-adjusted returns over the long term (see Table 1.1).

[2]According 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 1.1: 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 developer 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 1.1, traditional investments are primarily on-market opportunities[3] 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. 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 exchange or are redeemable through the mutual fund route with some restrictions.

1.1.1 Definition of Alternative Investment Fund (AIF)

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'*

[3]As 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.

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.

1.1.2 Investors in AIF

Internationally, the investors in an AIF are primarily large institutional funds such as pension funds, investment funds, insurance companies, endowment funds, investment banks, family offices and HNIs, fund of funds and AIF managers themselves. All these investors have large pools of funds managed by fund managers who would be seeking varied investment options beyond traditional investments. AIFs cater to the needs of such investors through alternative asset classes.

1.2 Alternative Investment Avenues

There are several avenues for creating alternative assets such as venture capital, private equity, hedge funds, Over-the-counter (OTC) and exchange traded derivative contracts, real estate, commodities, precious metals, arts and antiques. These are briefly explained below.

1.2.1 Venture Capital

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.

1.2.2 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. In normal terms, it refers to equity share capital only. In the context of private equity, it refers to the total capital raised from private investors even though the instrument used may not always be an equity share. This is because both venture capital and private equity investments have evolved over time to address various business situations faced by young and growing companies. Similarly, based on the evolution of alternative asset classes, private equity has also extended to providing debt capital through '*private debt'*. Therefore, the term 'private equity' refers to capital raised from private investors which can be 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. Accordingly, while most funds look at equity as the main instrument to provide capital, pure 'private debt funds' and hybrid funds are also prevalent in the industry. The SEBI (AIF) Regulations differentiate between private equity funds and pure debt funds. Therefore, these are explained as per the given classification in Unit 3.

1.2.3 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:

(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.[4]

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"*.

1.2.4 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

[4] 'Leveraging at fund level' means that the fund entity will borrow from market sources 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.

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 considerable market risk associated with the sector or illiquidity risk due to long gestation period. Some of these are also structured as real estate 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 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.

1.2.5 Commodities

Commodities such as metals (both precious and non-precious) are used as underlying assets for alternative investment. Just as gold and other precious metals, gems and jewellery are used as hedge against inflation; commodities often serve the same purpose. Though soft commodities such as agricultural produce including cash crops such as cotton, coffee etc. are more common in trade and speculation, alternative investors usually look for opportunities in hard commodities such as oil & gas and metals (such as copper, aluminium and precious metals).

1.2.6 Others

Apart from the above, alternative investment asset classes include gems and precious stones, arts and antiques, film funds, sports, vintage wines, stamps and collectibles. India is witnessing unprecedented growth in the FinTech platforms, which offer returns to investors on the platform in the form of interest, rental yields or equity shares of start-ups and unlisted companies.

1.3 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 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 investable 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. The fund management industry grew enormously in the 1970s and 80s as well. 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.

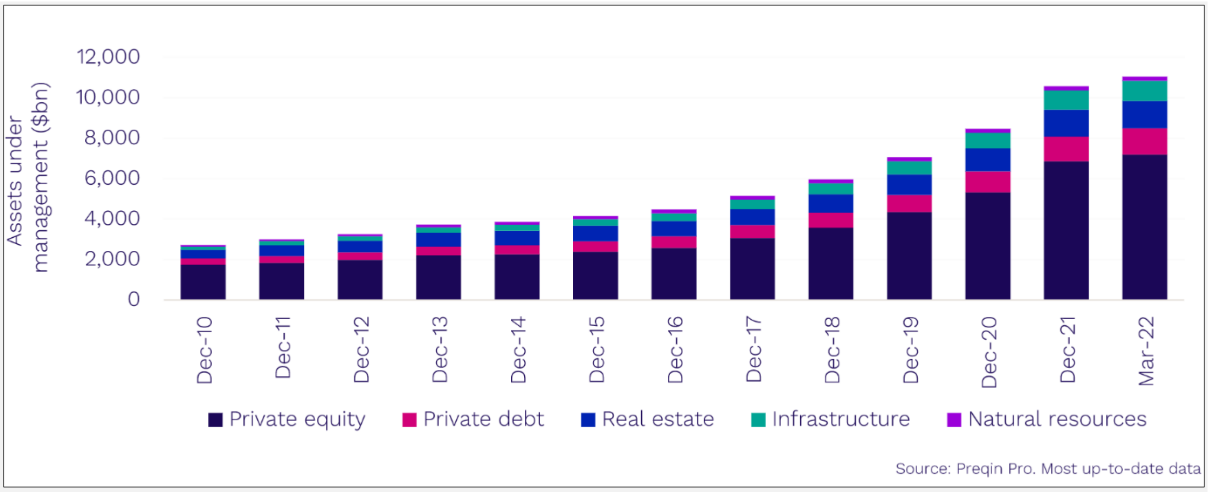
In the US, the VC industry got further boost when the Small Business Investment Act was passed in 1958 which provided recognition and tax breaks for small business investment companies and regulation through the Small Business Administration. The Act also enabled banks to invest in such VC companies which then witnessed explosive growth. During the latter part of the twentieth century, the VC model refined itself and positioned itself as risk capital to early stage technology companies.

In the 1980s, the flow of funds into this industry was enormous with more types of investors getting into financing young unlisted business companies. The main trigger was of course the strong primary market for IPOs. Investors felt that nurturing good IPO candidates was a sure formula to profitable exits. This led to the explosion in both venture capital and later stage private equity financing funds. However, the industry had its share of setbacks during the late 1980s. The explosive growth of the industry meant shortage of good deals and expertise of professional private equity specialists. The industry suffered again during the dotcom bust in 2001 due to astronomical valuations and euphoria surrounding internet businesses. 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.[5] 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. Figure 1.1 shows the three-fold jump in alternative assets post-2008.

Figure 1.1: Alternative Assets

[5] Global Private Equity Report 2019, Bain & Company



USD 13.7 trillion in AUM across all alternative asset managers globally (as of December 2021)

1.4 Role of Alternative Investments in Portfolio Management

Portfolio management needs to be ever-evolving 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. Due to economic slowdown in developed economies, central banks of the world have been using expansionary monetary policy and even zero or negative benchmark rates to revive their economies. This has caused fall in investment returns in developed markets and a shift to emerging markets in the past two decades.

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 the 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 1.2 represents the position.

Figure 1.2[6]

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 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 1.2 captures the strengths and limitations of alternative investments.

Table1.2: 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.

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

BENEFITS	LIMITATIONS
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 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, interest rate changes by central banks 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.

Chapter 1: Sample Questions

1. 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

2. 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

3. The SEBI (Alternative Investment Funds) Regulations, 2012 define an AIF as a ________ structure.

a. financial

b. NBFC

c. corporate

d. privately pooled

4. A securitisation company floated by a bank is NOT an AIF under the SEBI (Alternative Investment Funds) Regulations, 2012. State whether True or False.

a. True

b. False

5. Alternative investment funds provide risk capital to businesses that have very high probability of failure due to their complex technologies. State whether True or False.

a. True

b. False

Chapter 2 – Growth of Alternative Investment Funds in India and Suitability of Category III AIFs

LEARNING OBJECTIVES:

After studying this chapter, you should know about:

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

2.1 Evolution and Growth of Category III AIFs in India

Evolution of Hedge Funds: Up to 2012

The term "hedge funds", first came into use in 1949, when Alfred Winslow Jones's company, A.W. Jones & Co. launched the first hedge fund. "Hedge Funds" were described as any investment fund that used incentive fees, short selling, and leverage to maximize returns for the investors. Over time, hedge funds began to diversify their investment portfolios to include other financial instruments such as fixed income securities, convertible securities, currencies, exchange traded futures contracts, commodity futures and commodity options.

Indian capital markets witnessed significant growth in the 1990s. With the notification of rules and regulations governing Portfolio Managers and SEBI (Mutual Funds) Regulations, the asset management business took shape in the private sector in India.

Foreign Investors were investing significant funds through Hedge funds and Funds-of-Funds, set-up in offshore jurisdictions. Such funds invested directly in Indian Securities Market, or through Offshore Derivative Instruments (ODIs), issued by Foreign Institutional Investors (FIIs) against underlying Indian securities. As at end of March 2004, the hedge funds accounted for about 5 percent of the market value of the total assets held by the FIIs in India.

Eurekahedge India Long Short Equities Hedge Fund Index is an equally weighted index of 15 constituent funds. The index was designed to provide a broad measure of the performance of underlying hedge fund managers who invest exclusively in India. The index is base weighted at 100, as on December 1999. As seen from Figure 2.1, the India-focused hedge funds have shown consistent returns, even after a decrease in the index value during the Global Financial Crisis of 2008.

Figure 2.1: Historical Performance of Eurekahedge India Long Short Equities Hedge Fund Index, since inception

However, no hedge funds were domiciled in India. Offshore hedge funds were not able to offer their products to Indian investors within India as there was no regulatory regime for hedge funds to be set up or marketed in India.

- Any offering of shares to at least 50 persons would constitute a public offering and the fund would be required to issue and register a prospectus for the same.
- As per RBI Circular No. 80 dated March 18 2004, any Indian Bank appointed by offshore funds, to market their products in Indian markets, had to seek prior approval from RBI for acting as an agent of such overseas funds.
- Some hedge funds were not being regulated by the respective securities regulator(s) in their country of incorporation, due to which they were prohibited to enter the Indian Securities Market as an FII, as per the erstwhile SEBI (Foreign Institutional Investors) Regulations. However, Hedge Funds could invest through a 'sub-account', if sponsored by a registered Foreign Institutional Investor and meeting the requirements of 'fit and proper' persons.

Furthermore, on account of the absence of full capital account convertibility, the general principles of corporate law and exchange control laws were applicable to such funds. As a result, Indian residents were not permitted to invest in foreign securities, except in accordance with the regulations framed under the Foreign Exchange Management Act, 1999, or as prescribed by the Reserve Bank of India, from time to time.

Considering the above-mentioned restrictions, hedge funds had limited options for marketing their products to Indian investors, as mentioned under:

<u>Indian Resident Individuals</u>:

- On February 4, 2004, RBI introduced a Liberalised Remittance Scheme (LRS) which permitted Indian resident individuals to invest up to USD 25,000 per year for any purpose including investment in foreign securities.[7] Subsequently, this ceiling was increased up to USD 250,000 per individual, per financial year, in June 2015[8] However, foreign hedge funds had minimum investment limits as high as USD 100,000 per investor, hence limiting the capital inflows from Indian investors in India.

- Alternatively, Indian resident individuals were permitted to acquire foreign securities if the consideration for such foreign securities was paid out of a Resident Foreign Currency (RFC) account.

<u>Indian Mutual Funds</u>:

Indian mutual funds could invest only up to 10 percent of its net assets in foreign securities. Hence, a limited number of qualified mutual funds were allowed to invest in overseas exchange traded funds.

<u>Indian Listed Companies</u>:

Indian listed companies were permitted to invest in foreign companies listed on a recognised stock exchange.

Identification of Hedge Funds: Up to 2012

An approach for identifying hedge funds, as suggested by International Organization of Securities Commission (IOSCO) was to look at the characteristics of fund management

[7]RBI Circular No.: RBI/2004/39 dated February 4, 2004 on Liberalised Remittance Scheme of USD 25,000 for Resident Individuals.
[8] RBI Circular No.: RBI/2013-14/620 A.P. (DIR Series) Circular No.106 dated June 1, 2015 on Liberalised Remittance Scheme for Resident Individuals- Enhancement of limit.

strategies employed by such funds. In order to be recognized as Hedge funds, they would need to at least exhibit some of the following characteristics:

i. Non-applicability of borrowing and leverage restrictions.
ii. Significant performance fees are paid to the investment manager, in addition to an annual management fees.
iii. Investors are typically permitted to redeem their interests periodically, i.e. quarterly, semi-annually or annually.
iv. Investment of significant 'own' funds by the investment manager.
v. Use of derivatives, often for speculative purposes, with the ability to short sell securities.
vi. More diverse risks or complex underlying products are involved.

Registration of Hedge Funds as Foreign Institutional Investors: Up to 2012

In 2004, SEBI was providing a limited window to Hedge Funds, to seek registration within the existing framework of the SEBI (Foreign Institutional Investors) Regulations as an FII, with the following additional provisions to control and monitor the inherent risks within Hedge Funds:

i. The investment adviser to the hedge fund had to be a regulated investment advisor under the relevant Investor Advisor Act or the fund had to be registered under Investment Companies Act.
ii. At least 20 percent of the corpus of the fund had to be contributed by institutional investors such as pension funds, university funds, charitable trusts or societies, endowments, banks and insurance companies.
iii. The fund manager or investment adviser was required to have a minimum experience of at least 3 years of managing funds, with similar investment strategy that the applicant fund has adopted.

Trends post 2012:

The Hedge Fund industry was at a nascent stage until 2012, post which SEBI introduced the SEBI (Alternative Investment Funds) Regulations on May 21, 2012. These Regulations identified Hedge Funds under "Category III AIF" which follows diverse and complex investment strategies, akin to investment strategies followed by Hedge Funds, globally. The period between 2012 and 2019 can be termed as the consolidation and transformation phase for the Category III AIF industry in India, which witnessed a plethora of government reforms and market developments, as discussed below:

- The AIF industry caught the fancy of the ultra-rich billionaires of India who numbered 169 in Forbes list of World's Billionaires in April 2023. During this phase, several new fund houses and investment managers set up or launched new Category III AIFs, to cater to the wealthy Indian investor community.
- As per Notification No. FEMA 355/2015-RB dated November 16, 2015, the Reserve Bank of India liberalised the investment restrictions on Persons Resident outside India including Registered Foreign Portfolio Investors (RFPI) or Non-resident Indians (NRIs) to invest in AIFs. Investments made by AIFs in India, are considered as foreign investment, if neither the Sponsor nor the Manager is Indian 'owned and controlled'. The notification further stated that a Category III AIF with foreign investment shall make portfolio investment in such securities and instruments in which RFPIs are allowed to invest.
- Important recommendations were made by the SEBI Alternative Investment Policy Advisory Committee (AIPAC), headed by Shri Narayan Murthy, in order to improve the tax regime for Category III AIFs as well as boost the inflow of capital from domestic institutional investors such as Banks, Insurance Companies, Pension Funds, Charitable Organizations, Family Offices and High Net worth Individuals.
- Rationalization 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 launch Category III AIFs in India and make investments, with greater flexibility. As per the structure of Category III AIFs, 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. However, mutual fund managers are only permitted to charge 'Management Fees', over and above the 'Administrative Costs' and other expenses borne by the fund.
- All Category III AIFs registered with SEBI are monitored as per the Operational Guidelines and Risk Management Framework, including the prudential norms and leverage limits specified from time to time.
- Investors in Category III AIFs are kept well-informed on a monthly-basis as well as quarterly-basis, with respect to important aspects of the fund such as total funds raised, total investment exposure, concentration limits and leverage taken.
- The domestic Category III AIF market grew by identifying new alternative investment opportunities, such as taking exposures in exchange-traded Commodity Futures and Commodity Options contracts.
- Category III AIFs making investments in listed mid-cap and small-cap securities and implementing hedging strategies, through stock-based and index-based futures and

options contracts, have emerged. Some of the funds also focus on special situations such as merger arbitrage, buybacks, de-listings, open offers, rights offers and convertible arbitrage.

2.2 Types of AIFs

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 can register the following types of funds as AIFs: –

2.2.1 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.[9]

"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.

2.2.2 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:

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

(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
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.

2.2.3 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"[10]. It may be understood that private equity fund is primarily an equity-based 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.

2.2.4 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."[11]

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.

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[10] Equity linked instruments include instruments convertible into equity shares or share warrants, preference shares, debentures compulsorily or optionally convertible into equity.
[11] Inserted by the SEBI (Alternative Investment Funds) (Fourth Amendment) Regulations, 2018 w.e.f. August 13, 2021

Some private debt funds also use Securitized Debt Instruments as a pooled investment vehicle for asset financing. The pool of funds raised by issuing Securitized Debt Instruments to investors, are used to purchase assets such as cars, trucks, electric vehicles, which are leased to corporate clients and the rental income is passed on to the investors.

Distressed debt financing through private debt funds is also catching on in India in the form of refinancing settlements with banks and insolvency resolution schemes under the Insolvency and Bankruptcy Code (IBC) proceedings. Distressed financing provides capital for companies with heavy debt burden to turn around or to help in their acquisition by new owners, through auctions that are conducted under the Insolvency and Bankruptcy Code, 2016. Such processes are known as 'insolvency resolution'.

2.2.5 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.

2.2.6 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.

2.2.7 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".

2.2.8 Social Impact Fund[12]

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
- Micro-finance Institutions

2.2.9 Special Situations Fund[13]

Special Situations Fund is "an AIF which invests in special situation assets, in accordance with its investment objectives, and may act as a resolution applicant under the Insolvency and Bankruptcy Code, 2016."

Special Situation Assets include:

- Stressed loans available for acquisition as per Clause 58 of Master Direction - Reserve Bank of India (Transfer of Loan Exposures) Directions, 2021
- Stressed loans available for acquisition as part of a Resolution Plan approved under the Insolvency and Bankruptcy Code, 2016 (IBC)
- Security Receipts issued by an Asset Reconstruction Company (ARC), registered with the Reserve Bank of India (RBI)
- Securities of companies:
    - whose stressed loans are available for acquisition, as mentioned above.
    - against whose borrowings, Security Receipts have been issued by an ARC.
    - whose borrowings are subject to corporate insolvency resolution process under IBC, with a credit rating of 'D' or equivalent.
    - who have disclosed all defaults relating to payment of interest and principal on loans/debt securities issued by the company. In this case, the default should be continuing for ninety calendar days after declaration of such default, and the loans/debt securities of the company should have a credit rating of 'D' or equivalent.

[12] Inserted by SEBI (AIF) (Third Amendment) Regulations, 2022 w.e.f. July 25, 2022.
[13] Inserted by SEBI (AIF) (Amendment) Regulations, 2022 w.e.f. January 24, 2022.

2.2.10 Corporate Debt Market Development Fund[14]

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. 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.

2.2.11 Categories of AIFs

All the types of funds that have been described above are divided into three categories under the SEBI (Alternative Investment Funds) Regulations for the purpose of registration and other operational requirements. These categories are mentioned below.

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.

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 to meet day-to-day operational requirements or 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.

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

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

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.

SEBI has inserted a fourth category of AIF known as the Specified AIF.[15] This category includes Corporate Debt Market Development Fund as discussed above.

2.3 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 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 2.1 compares and contrasts between the categories of AIFs.

Table 2.1: 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	All AIFs that do not classify under Category I AIF or Category III AIF.	Employs diverse or complex trading strategies and may employ leverage

[15] SEBI (Alternative Investment Funds) (Second Amendment) Regulation, 2023 w.e.f. June 15, 2023.

Parameters	Category I AIF	Category II AIF	Category III AIF
	other sectors as may be specified.		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, these funds assume higher risks seeking higher return. But risk mitigation strategy is to invest in smaller tranches.	Generally, less risky than Category III AIF. Primarily seek returns from value creation and unlocking value by investing in later stage companies.	Complex risk-taking strategies including trading with borrowed funds at fund level.

2.4 Suitability and Enablers for Category III AIFs in India

India has seen tremendous economic growth in almost three decades of 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. India's economic prosperity has been underpinned by the increasing tribe of billion dollar ultra-high net worth investors (UHNI).

Non Resident Indians (NRIs) and Foreign Portfolio Investors (FPIs) have been investing in Indian Alternative Investment Markets, after the FEMA Notification in 2015.[16] The regulatory impetus to the Indian Alternative Investment Market has been provided with the introduction of the SEBI (Alternative Investment Funds) Regulations, 2012. These regulations provided the

[16] FEMA Notification No.: FEMA 355/2015-RB dated November 16, 2015.

necessary framework which made Category III AIFs marketable, regulated, transparent and safe for the sophisticated investors.
In 2015, the Government of India announced the establishment of Gujarat International Financial Tec-City (GIFT City), in Gujarat as India's first International Financial Service Centre (IFSC). Several regulatory measures were introduced to operationalize the IFSC, which aided in providing financial services that were provided by overseas financial institutions located in sophisticated offshore financial hubs like Singapore, Hong Kong, Mauritius and Luxemburg, among others. The SEBI (IFSC) Guidelines, 2015, provide directives to regulate activities of various securities markets intermediaries, including AIFs operating in IFSC.

Furthermore, 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 companies. In addition, with improved governance regulations and management practices, the small-cap companies and SME sector have immense potential to cater to the alternative asset class of investors. In view of these developments, the Category III AIF sector is most suitably positioned for investors and investee companies in India in the coming years.

2.4.1 Category III AIF suitability based on Investors' risk-return profile

Category III AIFs deploy complex strategies with a view to make short-term gains and generate alpha.[17] Among all three categories of AIFs, Category III AIF is the riskiest one.

Category III AIFs are most suited, only for institutional investors and ultra-high net worth individuals, considering the risk-return profile of the fund. Every investor must judge the suitability of the investment in Category III Funds, to their individual risk-return profiles and investment constraints. Category III Funds are allowed to take leverage positions through Futures and Options (F&O) contracts, structured products, credit default swaps, margin trading and arbitrage strategies, with the purpose of earning speculative profits, or hedging their current exposures in the portfolio. This adds to the overall portfolio risk for the investor. Investors, before investing, should particularly look at some of the crucial clauses in the Private Placement Memorandum (PPM), 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.

[17]Alpha is the excess return generated by a Category III AIF, when compared with the return generated by the benchmark index.

- "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/Investment 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.

For example, let us discuss the suitability of Category III AIFs for an HNI investor looking to make investments over a one-year time horizon. The HNI investor would be hesitant to invest in a "closed-ended" Category III AIF, investing in small-cap and mid-cap securities. Closed-ended Category III AIFs have a minimum tenure of 3 years, generally with an additional mandatory lock-in period of 2 years. Investors can redeem their units after 2 years by paying the applicable exit load. Even if the Category III AIF is generating above-average returns and has appointed an experienced Manager, the investment in this Fund will not be feasible for the HNI investor given the liquidity constraints.

2.4.2 Asset allocation for HNIs and Institutional investors through Category III 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. Keeping in mind Category III AIFs further invest in traditional assets, such as listed equities, it is important to allocate funds strategically in order to avoid further concentration of the portfolio.

Let us look at an example of asset allocation for an HNI investor, considering an investment in a Category III AIF:

Mr. X, aged 41 years, is having a portfolio of Rs. 100 crore and is currently invested in the following asset classes.

Particulars	Allocation
Equities:	
Domestic – Large-cap Stocks	25%
Domestic – Small-cap Stocks	25%
Domestic – Unlisted Securities	20%
Fixed Income:	
Domestic – Listed Corporate Debt	15%
Government Bonds	10%
Money Market Instruments:	5%
Total	**100%**

The investor has capped current and future exposure to one particular asset class to maximum 40%. Mr. X is now looking to re-allocate the current investments in Domestic Unlisted Equities to 2 potential Category III AIFs:

- Category III AIF “A” – follows a long-short strategy, investing only in Small-cap companies, with a 3-year investment horizon.
- Category III AIF “B” – follows a market-neutral strategy, investing 35% in domestic small-cap securities, 50% in overseas listed securities, primarily in Middle East, and remaining 15% in domestic large-cap stocks.

From the above example, let us understand the asset allocation strategy for the investor:

- Based on the age of the investor, past investment experience and the current investment portfolio, it is imperative that the HNI investor has the “ability” and “willingness” to take risk and generate additional returns. Hence, the HNI investor would re-allocate to a Fund which has a high growth potential (in this case Category III AIF “A”).
- Based on the concentration limits, the investor will not want to allocate the entire amount to Category III AIF “A”, as it would result in “direct and indirect” allocation of more than 40% towards Domestic Small-cap companies. Further, by allocating to Category III AIF “B”, Mr. X would be able to diversify the portfolio and get indirect exposure towards international securities as well.

- In this case, Mr. X has multiple options, either to allocate entire Rs. 20 crore to Category III AIF "B" or allocate part of funds to Category III AIF "A" and remaining to Category III AIF "B". In the second option, the maximum allocation to Category III AIF "A" would be Rs. 15 crore.

2.5 Current Category III AIF Market Status

Category III AIF market has grown manifold post SEBI (AIF) Regulations came into effect in 2012. As on June 1, 2023, 1128 AIFs were registered with SEBI. Starting with just 21 funds in 2012, the industry has seen a 34-fold jump in about ten years, in terms of number of registered AIFs.

Table 2.2 reveals the capital commitments raised and investments made by Category III AIFs over the last few years ending March 2023.[18]

Table 2.2: Commitments raised and Investments made by Alternative Investment Funds

(Rs. in crore)

As on	Cumulative net figure as at the end of period mentioned			
	Category III AIFs		All Categories of AIF	
	Commitments Raised	Investments Made	Commitments Raised	Investments Made
September 30, 2015	3516	2303	27485	11255
September 30, 2016	8081	6010	65012	24862
September 30, 2017	22657	13227	116085	43489
September 30, 2018	40586	26755	217229	84474
September 30, 2019	42223	30961	316863	125806
September 30, 2020	49364	36963	405118	165673
September 30, 2021	57953	50867	535008	244407
September 30, 2022	73445	63176	702737	307845
March 31, 2023	80900	71055	833774	337982

As observed from Table 2.2 above, Capital commitments raised by all registered AIFs have surpassed Rs. 8 trillion as on March 31, 2023. It can be observed that Category III AIFs have constantly invested most of the capital commitments, after a successful fund-raise in the respective periods. For example, up to March, 2023, almost 88 percent of the cumulative capital commitments raised by Category III AIFs have been invested, as per the stated investment strategy. Upon direct comparison, it is observed that Category I AIFs and Category II AIFs been investing almost 35% of the cumulative capital commitments as on March, 2023.

[18]https://www.sebi.gov.in/statistics/1392982252002.html

This can help us draw the conclusion that Category III AIFs in India have been investing the funds faster, to generate alpha by employing diverse trading strategies, with or without Leverage positions through Futures and Options (F&O) contracts.

Chapter 2: Sample Questions

1. **Alternative Investment Funds which primarily invest in debt securities of listed or unlisted investee companies are known as _____________.**

   a. Venture Capital Funds
   b. **Debt Funds**
   c. Angel Funds
   d. Infrastructure Funds

2. **The Category of Alternative Investment Funds which are permitted to take leverage positions, through Futures and Options (F&O) contracts, structured products, margin trading and arbitrage strategies, are known as _____________.**

   a. Category I AIFs
   b. Category II AIFs
   c. **Category III AIFs**
   d. All of the above

3. **SEBI introduced the SEBI (Alternative Investment Funds) Regulations on May 21, 2012. State whether True or False.**

   a. **True**
   b. False

4. **Which of the following sections of the Private Placement Memorandum will most likely provide details on the prior experience of the Investment Manager of the Category III AIF?**

   a. Investment Objective and Strategy
   b. Terms of the Fund/Scheme
   c. Redemption
   d. **Manager**

5. **Category III AIFs in India have been investing the funds faster, in order to generate alpha by employing diverse trading strategies. State whether True or False.**

   a. **True**
   b. False

Chapter 3: Introduction to Category III AIF Ecosystem

LEARNING OBJECTIVES:

After studying this chapter, you should know about:

- Investments and characteristics of funds under Category III AIFs
- Category III AIF ecosystem (Investors/ Sponsors/ Trustees/ Managers)
- Concepts prevalent in Category III 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
- Comparison of Category III AIF with PMS and Mutual Funds
- Role of Category III AIF in portfolio diversification
- Use of Category III AIF as a risk management tool (Alpha/ Beta management)

3.1 Investments under Category III AIF

Category III Alternative Investment Fund (AIF) is a form of a pooled investment vehicle with a diversified investment mandate, which enables a Manager to invest in various asset classes, such as equities, fixed income securities and take dynamic exposures through leverage strategies, as per the stated investment mandate of the fund. Category III AIFs are permitted to take leverage positions through futures and options (F&O) contracts, structured products, credit default swaps, margin trading and arbitrage strategies, with the purpose of earning speculative profits, or hedging their current exposures in the portfolio. Based on the investment strategy of the Category III AIF, such as Long-short Funds, Managers may take short positions in equity securities or fixed income securities to maximise gains or for the purpose of hedging the current portfolio exposure.

Investment strategies followed by Category III AIFs can be much riskier, when compared to its traditional counterparts such as Mutual Funds. Hence, Category III AIFs pool money from high net-worth individuals (HNIs) and institutional investors, based on their risk appetite to invest in such funds.

Common investments using Category III AIF structure are made by PIPE (Private Investment in Public Equity) Funds, Hedge Funds and similar funds which use diverse and complex investment strategies to make investments in listed and unlisted equities, derivatives, currencies, convertible securities and fixed income securities, as specified by the SEBI (AIF) Regulation, 2012.[19]

Category III AIFs can directly invest into an investee company or invest through units of other Category I AIFs and Category II AIFs, registered with SEBI, without labelling themselves as a Fund of AIFs.[20] Category III AIFs are governed by the investment restrictions and regulations mentioned in the SEBI (AIF) Regulations.

3.2 Characteristics of Category III AIF

Category III AIFs follow a stated investment strategy, mentioned in its offer document, or Private Placement Memorandum (PPM). The PPM is issued by the Category III AIF Investment Manager or Sponsor of the fund to prospective investors for the purpose of inviting subscriptions to units of a new scheme.

"Unit" means beneficial interest of the investors in the AIF or a scheme of the AIF and maybe fully or partly paid-up. Partly paid-up units represent the portion of the committed capital invested by the investor in AIF or scheme of the AIF.[21]

The PPM sets out the broad terms and conditions subject to which the fund is proposed to be operated, associated risk factors, potential conflicts of interests, fee structure, distribution waterfall, taxation aspects, applicable regulatory norms and necessary disclosures in connection therewith. The PPM of a Category III AIF is of particular relevance to distributors and is fundamental to marketing the right product to investors as well as explaining the potential return and risks therein.

❖ **Investment Strategy:**

The investment strategy describes the type(s) of asset classes in which the Category III AIF will invest in. For example, if the Fund proposes to invest in equities, the investment strategy will outline the following:

- <u>Market-capitalization of Target Companies</u> – The Category III AIF states whether they aim to invest in small-cap companies, mid-cap companies or large-cap companies, based on the expertise of the investment manager and the risk-return profile of the

[19]PIPE Funds purchase securities of a publicly traded stock, at a discount to the Current Market Price of such security being traded, whether in the primary market or secondary market.

[20] Vide SEBI Circular No.: SEBI/HI/IMD-IDF6/P/CIR/2021.584 dated June 25, 2021 on Circular on Amendment to SEBI (AIF) Regulations, 2012.

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

Fund. Many Category III AIFs willing to take higher risk may also choose to invest in SME companies or micro-cap companies or by taking exposure through securitized debt instruments. Some Category III AIFs also make overseas investments in listed investee companies.

- Investment Style – Category III AIFs may prefer investing in Value Stocks, i.e. companies which are generally under-priced at present market prices and have a reasonable future growth trajectory, or Growth Stocks, i.e. companies with high growth projections and have expected growth rates in sales/profit to be higher than the industry average. Managers can also use a GARP (Growth at a Reasonable Price) investment style, which combines the tenets of Value Investing and Growth Investing, while making stock selection.

- Asset Allocation and Stock Selection – Category III AIFs may take diversified positions or concentrated positions in Value stocks or Growth stocks, based on the investment style adopted. The Investment Manager determines industry allocation and assigns maximum weight to be given to every industry and sector, in the fund portfolio. After determining industry weights and allocation, stock selection can be done within the targeted industry allocation, subject to regulatory limits. Managers of AIFs are permitted to invest maximum 10 percent of the investable funds in one investee company directly or through investment in units of other Alternative Investment Funds. This limit for investment managers of 'large value funds for accredited investors' is increased to 20 percent. However, for investment in listed equity of an investee company, this investment limit can be calculated based on either "Investible Funds" or "Net Asset Value" of the scheme launched by a Category III AIF.[22]
  "Large Value Fund for Accredited Investors" is 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 Rs. 70 crore.[23]

- Investment Horizon – The PPM of a Category III AIF outlines the targeted investment horizon and holding period of portfolio investments, depending on the structure of the fund being an open-ended fund or a closed-ended fund. Managers of open-ended Category III AIFs should ensure that there is sufficient liquidity in the fund to meet potential redemption calls of investors.

- Investment Approach – Based on the investment strategy, targeted allocations, risk-return objective and the time horizon of investments of the Category III AIF, the Investment Manager shall frame the preferred investment approach for making

[22] Inserted by the SEBI (Alternative Investment Funds) (Second Amendment) Regulations, 2022 w.e.f. March 16, 2022.
[23] Inserted by the SEBI (Alternative Investment Funds) (Third Amendment) Regulations, 2021 w.e.f. August 3, 2021.

investments. One Manager may take leverage, short positions in equities or derivatives exposure with the objective of earning profits in trading; while another Investment Manager may take derivatives exposure with the objective of hedging the inherent market risk in portfolio investments.

The Investment Strategy of a Category III AIF is discussed in detail in Unit 7.

- **Professional Managers and Fee-Structure:**

Managers of AIF and their team managing the Category III AIF are experts in capital markets and investment, especially in the industry or sector or geography the fund is investing in. Most managers come with minimum 5 years of experience dealing in equities, fixed income securities and derivatives and hence are able to take an investment call on behalf of their investors.

For the investment management services provided by the fund management team, Managers charge a fixed Management Fee, generally 1 percent to 2 percent on Total Capital Commitments made by the unit-holders. Over and above the fixed fees, Managers can charge an Incentive Fee which is a share in 'Profit' or 'Additional Return' earned by the Fund, in excess of the Hurdle Rate set in the PPM.[24] Incentive Fees can range from 0 to 20 percent of the Additional Return, depending on the size of the assets managed by the fund, years of operation, total capital invested and hurdle rate.

The Fee Structure of a Category III AIF is discussed in detail in Unit 6.

- **Liquidity:**

In order to execute complex investment strategies, Managers need consistent capital inflows and freedom to use leverage. Managers may not be able to produce the required return on capital, if there are multiple redemptions by investors. Untimely redemptions can force managers to exit positions at undesired price levels. As per the present taxation structure, Category III AIFs are required to pay income tax on income earned from investments, which can be a significant cash out-flow for some funds, based on their legal and taxation structure. Hence, investors in Category III AIFs may be required to lock-in their capital, once they invest in the Fund, for a particular period of time.

However, considering the risk factors inherent in Category III AIF investment strategies, it is fair for investors to be given flexibility to exit from the fund, in case the manager does not perform as per expectations or takes unexpected risk, in order to provide the target return.

[24]Hurdle Rate is the minimum rate of return to be accrued to fund investors every year, of the fund operation.

Hence, Category III AIFs have the option of being structured as open-ended funds or closed-ended funds. Category III AIFs structured as closed-ended funds offer limited redemption options to the investors, as compared to open-ended funds.

- **Portfolio Diversification:**

Category III AIFs invest in multiple asset classes, based on their investment strategy. Investment Managers offer a range of investment opportunities, which may otherwise not be available to investors who invest directly in securities market. Investment Managers of Category III AIFs can provide increased benefits of portfolio diversification to an investor, with a diversified investment strategy, use of leverage and derivative exposures.

- **Investors:**

Category III AIF investors need to face the risk of illiquidity and increased market risks, on account of derivative exposures and use of leverage. Depending on macro environment such as market sentiments, government reforms and other global factors which are not in control of the Investment Manager of AIF, the returns of the Fund may fluctuate and increase the overall volatility of the portfolio.

Investors willing to invest in Category III AIFs must be aware of such risks and accordingly be capable to climb the risk-return trade-off, in search for superior returns.

- **Taxation:**

Category III AIFs are liable to pay income tax on income earned as interest, dividend, profits earned and capital gains on transfer of securities. Unlike Category I AIFs and Category II AIFs, Category III AIFs are presently not entitled the benefits of pass-through tax status. Therefore, any taxable source of income is first charged to the Category III AIF and the fund is liable to pay tax on such income earned.

The Taxation structure of a Category III AIF is discussed in detail in Unit 9.

3.3 Concepts prevalent in the Category III 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 Category III AIFs (more often the investment managers themselves) and (d) the external service providers who facilitate and make up the ecosystem. With the advent of an organized AIF industry and introduction of the SEBI (Alternative Investment Funds) Regulations, 2012, Category III AIFs have witnessed significant growth after 2012 and many of these constituents of the private capital ecosystem are taking shape rapidly.

3.3.1 Category III AIF Ecosystem:

3.3.1.1 Investors

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

Foundations and Endowments: A Foundation is a not-for-profit organization that donates funds and provides support to other organizations, 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.

Insurance Companies and Pension Funds: Investments from both private and public sector pension funds have been a significant catalyst in the growth of Category III AIFs and hedge funds, 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 Category III 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 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: 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, which stands at 6.35 percent of the Total Hedge Funds AUM globally.[25]

Indian Category III AIFs are still at a nascent stage and are poised to grow exponentially, with expectations of large capital pools from foreign portfolio investors, domestic institutional investors and ultra-high net worth individuals.

SEBI recently introduced the framework for Accredited Investors (AIs) in the Indian securities markets. As per the framework, 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 Unit 5.

3.3.1.2 Sponsors

Sponsor means any person or entity that is responsible for the formation and registration of the Category III AIF with SEBI, and includes promoter in case of a company and designated partner in case of a limited liability partnership. After seeking registration of Category III 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 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

[25] Barclays Hedge Report, Q1, 2023.

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.

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

- **Appointing a Custodian**: The Sponsor or Manager of a Category III 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 Category III 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 Category III AIF shall be audited annually by a qualified auditor.
- **Dispute Resolution Mechanism**: The Category III 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 Category III 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 Category III AIF with respect to activities of fund, assessment of systemic risk or prevention of fraud.

The 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.

Conflict of Interests:

The Sponsor and Investment Manager of a Category III 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 Category III AIF shall have a Conflict of Interest Policy, which helps to identify and mitigate the potential conflicts. Investment Managers and Sponsors have the responsibility to monitor the compliance towards the conflict of interest policy.

A Category III AIF can have potential sources of conflicts at various levels, when making co-investments, or dealing with service providers, clients or employees of the fund. The Investment 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.
- No potential conflict should prevail between investors and the investment manager of AIF.
- 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 Investment 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 Category III AIF, or sponsor/investment 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 Category III 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 at the Category III AIF, generally overseen by the Investment Manager of AIF. 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

3.3.1.3 Trustees

A Trustee or Trustee Company is appointed when the Category III 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 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.

3.3.1.4 Investment Managers

Investment Manager is the person or entity that is appointed by the Sponsor of the Category III AIF, to manage its investments and may also be same as the sponsor of the Fund. The Investment Manager should have the necessary skill and expertise to identify favourable investment opportunities and have a minimum 5 years of work experience in financial services, investment planning, portfolio management and investment management.

The Investment 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. Investment 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.

The Investment 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 Investment 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 Category III AIF appoints an asset management company in which the investment managers are the principal executives and key managerial personnel. In limited liability partnership (LLP) structure that is widely prevalent abroad, the investment managers are known as general partners or GPs.

3.3.2 Capital Commitment and Sponsor Commitment

Capital commitment refers to the total funds to be contributed by investors for subscription to the Category III AIF, during the life of the fund. Individual capital commitments of each investor are based on their capital allocations to the Category III AIF, which may be different for institutional investors and non-institutional investors. Under the SEBI (Alternative Investment Funds) Regulations, 2012, a Category III AIF shall not accept from an investor, a capital commitment of value less than Rs. 1 crore.[26] However, if the investors are the employees or directors of the Category III AIF or the employees or directors of the Manager, the minimum investment value by such employees or directors is Rs. 25 lakhs. Each scheme of the Category III AIF shall have a total corpus, i.e. total of capital commitments raised from investors, of a size of not less than Rs.20 crore.

Partly paid-up units shall represent the portion of committed capital invested by the investor in Alternative Investment Fund or scheme of the Alternative Investment Fund.
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'.

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 of a Category III AIF shall have a continuing interest of not less than 5 percent of the corpus of the fund or Rs. 10 crore whichever is lower. 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. 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 Category III AIF to the investors.

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

Such continuing interest cannot be withdrawn from the fund and will remain locked-in until distributions to investors are completed in full.

3.3.3 Drawdown and Capital Invested

Drawdown is the process by which the manager of a Category III AIF will call the capital commitment from its investors, as per the funding requirements and investment strategy of the fund. These are known as 'capital calls'. Drawdown is usually made in accordance with the capital call schedule, mutually agreed with the investors in the Contribution Agreement.[27] Capital calls are issued by the Manager on the dates specified in the Agreement, which requires investors to deposit requisite capital amount by a pre-specified date and through a specific method of payment.

Managers should provide adequate details of how drawdowns are proposed to be made, which includes the following:

- <u>Schedule of drawdown</u>: The schedule should mention the amount of initial drawdown and the amount and timings of the subsequent drawdowns to be made during the commitment period, which can be a fixed periodic drawdown or drawdown on an 'as-needed' basis.
- <u>Notice period</u>: The number of days for the drawdown of capital. In case of failure of an investor to honour the capital calls, the agreement mentions about applicable interest fee and penalties, and further steps to be taken by the Investment Manager.
- <u>Investor Class-wise schedule</u>: Total amount of drawdown for each class of units issued to investors and the associated timelines.
- <u>Mode of issuance of drawdown notice</u>: Drawdown notice can be delivered physically or via email notices. Other modes of issuance used by the Category III AIF should be clearly communicated to the investors.

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

[27]Contribution Agreement records the terms on which an investor participates in a Category III AIF.

Since drawdowns are subject to the investment requirements and strategy implemented by the Manager, it is difficult for investors to forecast the timing of a capital call, in case of a drawdown on an 'as-needed' basis. Investors have to maintain sufficient liquidity and capital, in order to honour the capital calls during the drawdown period. In some cases, it is possible that the total drawdowns by the Category III AIF Manager are less than the total commitments, which may lead to an early termination of the fund. Similarly, it is possible that an investor has failed to honour a capital call, due to liquidity concerns or mis-timing the capital call.

3.3.4 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.

For Category III AIFs, 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 Category III 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 Category III AIF, to understand the investment risks in the proposed investment that is being marketed to a prospective unit holder.

3.3.5 Environmental, Social and Governance

Environmental, Social and Governance or ESG is a generic term for evaluating corporate behaviour and is 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. ESG norms are progressively defining the way businesses should operate. 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.

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 impact the performance of investment portfolios and should, therefore, be considered alongside more traditional financial factors, if investors are to properly fulfil their fiduciary duty. Several established fund houses in India are fast becoming signatories to this network such as Kotak, SBI, Avendus, among others. 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.

SEBI has introduced a Stewardship Code for all categories of AIFs, in relation to their investments in listed equity securities.[28] It is imperative for Category III 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:

- **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.
- **Principle 6**: AIFs should report periodically on their stewardship activities.

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.

[28]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.

3.3.6 First close and Final close

When investment managers launch a new Category III 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 Category III 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 Investment Manager of a Category III AIF should ensure that First Close is declared within 12 months from the date of SEBI communication for taking the PPM of the scheme on record.[29]

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.

3.3.7 Category III AIF Fees and Expenses

As discussed in the characteristics of Category III AIFs, the funds 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 a Category III AIF are discussed below:

3.3.7.1 Lock-in Period and Exit Load

Redemptions for a Category III AIF may result in frequent changes in the investment portfolio and a potential loss of return. In order to provide the flexibility to investment managers and encourage institutional investors to participate in Alternative Investments market, the manager of AIF can put a restriction on the redemptions allowed to an investor in a Category III AIF, by enforcing a lock-in period and exit load.

Category III AIFs can be structured as open-ended or closed-ended structures. Lock-in conditions are specified by the Manager. A closed-ended Category III AIF generally has a minimum tenure of 3 years, which is also the minimum tenure for a closed-ended Category I

[29] SEBI Circular No.: SEBI/HO/AFD-1/PoD/P/CIR/2022/155 dated November 17, 2022 on Guidelines for AIFs for declaration of first close, calculation of tenure and change of sponsor/manager or change in control of sponsor/manager.

AIF and Category II AIF. A 2-year lock-in, although not mandated by the SEBI (Alternative Investment Funds) Regulations, may be prevalent for most Category III AIFs. The Manager of the Category III AIF mentions the conditions applicable for redemptions, in the Private Placement Memorandum (PPM). These conditions state the investors' right to make full redemption or partial redemption and the 'redemption gates'. Redemption Gates provide the maximum amount of redemption permissible by investors, in every redemption period, subject to payment of applicable expenses, taxes and exit load.

Exit Load is the additional fees charged to investors, on redemptions made after completion of the lock-in period but before the expiration of stated fund tenure. Exit Load is pre-defined in the PPM and depends on the Manager, investment strategy and the time remaining until fund liquidation. After the Lock-in Period ends, Exit Load charged by Manager of AIF can range between 0 to 5 percent of the NAV of the fund. Some Managers may charge a variable Exit Load, such that the investors redeeming funds early would pay a higher Exit Load.

3.3.7.2 Management Fees

The reference to fees and expenses applies primarily to the management fees and expenses chargeable to the Category III AIF, as per the investment agreement 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 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 AUM 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 Category III 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 must 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.

3.3.7.3 Set-up Costs and Operational Expenses

Manager of a Category III 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, fees or commissions to be paid to intermediaries, 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.

A Category III 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.

The Operating Expenses of a Category III AIF is discussed in detail in Unit 6.

3.3.7.4 Hurdle rate and High-Water Mark

Hurdle Rate of Return, or ‘Preferred Return’, is the threshold return that the investors in the Category III 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.

Category III 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 a Category III AIF.

3.3.8 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 for the fund is calculated as the difference between the AUM of the Category III AIF 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 Category III AIF.

Managers can charge performance fees in the range of 0 to 30 percent. Most Category III 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 Category III 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 a Category III AIF is structured as a closed-ended fund.
The Fee Structure of a Category III AIF is discussed in detail in Unit 6.

3.3.9 Distributions and Distribution Waterfall

The amount of distributions to be made to the investors in a Category III AIF is determined based on the proportion of the NAV per unit and the total number of units held by each investor/class of investor in the fund. The Manager is responsible to determine the total amount of distributions available to investors, after paying/providing for:

- Fund expenses or any other costs, fees and expenses payable by the Fund, including the management fee.
- Liabilities of the Fund, including amounts required to be withheld or deducted as per taxation norms.
- Reinvestment of funds, as per the stated investment strategy.
- Meeting the prudential norms and providing for appropriate reserves within the fund.
- Funds to be used to pay Incentive Fees to the Investment Manager.

A Distribution Waterfall adopted by the fund describes the method followed to distribute the invested capital back to all its investors and the manager, along-with the gains earned on such capital.

A typical distribution waterfall followed by a Category III AIF is in the following order:

1. Return of capital contribution of investors

2. Payment of the preferred return, or the hurdle return to the investors in the fund

3. Payment of a catch-up rate to the investment managers. ‘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 20%).

   With a catch-up provision, the Manager 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 20%, as a higher proportion of the residual profits will be allocated to the manager.

4. After the catch-up rate is paid to the investment manager, any excess profits in the fund are then distributed to the investors, as the manager has been paid the share in profits through the catch-up clause.

Managers 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.

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.

Example1:

ABC Fund is a Category III AIF, launched on April 01, 2021. Following are the details of the fund:

Committed Capital	Rs. 50 crore
Fund Tenure	3 years
Total Assets under Management (at end of Year 3)	Rs. 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:

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

Rs. 70 crore – Rs. 50 crore = **Rs. 20 crore**

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

Rs. 20 crore * 20% =**Rs. 4 crore**

<u>Hurdle Return for 3 years</u>: 10% return yearly, for 3 years of the Fund Tenure

[Rs. 50 crore * $(1.10)^3$] – Rs. 50 crore = **Rs. 16.55 crore**

a. Scenario: No Catch-up Clause

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

Particulars	**Amount (Rs.)**
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 Rs. 3.45 crore (i.e. Rs. 20 crore – Rs. 16.55 crore), as per the Incentive Fees of 20%

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

Total Distribution:

Particulars	**Amount (Rs.)**
Manager	0.69 crore
Investors (Rs. 66.55 crore + Rs. 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 (Rs.)**
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 Rs. 3.45 crore, till the manager is paid the total pre-determined profit share in total profits of the fund, i.e. Rs. 4 crore. Since residual profits in Fund ABC are insufficient to provide for profit share of the manager, the entire residual profit of Rs. 3.45 crore will be distributed to the Manager.

Total Distribution:

Particulars	Amount (Rs.)
Manager	3.45 crore
Investors	66.55 crore
Total	**70.00 crore**

Conclusion:

It is observed that the total distribution to the Manager is Rs. 69 lakhs in the first scenario and Rs. 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.

3.4 Investments by Category III AIFs

In India, traditional asset classes like public equities have been most sought after investments, as they deliver the highest risk-adjusted returns, when compared to other asset classes, such as fixed income securities, government bonds and fixed deposits. Category III AIFs take dynamic exposures in public equities, whether or not by using a leverage strategy. Equity investments are the most common form of investments by Category III AIFs, in large-cap stocks, mid-cap stocks or small-cap stocks or in listed stocks or unlisted stocks.

Category III AIFs use complex strategies, which involve the use of derivatives, credit default swaps, short positions and leverage. Apart from public equities, some Category III AIFs also invest in commodities, as an asset class, using Commodities Futures and Options. This provides diversification benefits by investing across diverse asset classes.

Investments through PIPE (Private Investment in Public Equity) transactions are also a common mechanism followed by Category III AIFs to get exposure in listed stocks. PIPE transactions are increasingly becoming common, with some Category III AIFs looking to invest substantially in one single company to seek the benefits of active board management.

Apart from these asset classes and products, Category III AIFs can also invest in marketable securities that provide additional liquidity for payment of fund expenses. Such marketable securities include temporary liquid investments such as liquid mutual funds, bank deposits, Treasury bills, commercial papers and certificates of deposits.

Most common ways of investments, by Category III AIFs in India, include:

- **Taking market-neutral equity positions or selling short:** Category III AIFs do not necessarily have to only "buy" securities for investment. These funds are allowed to take net short positions in equity stocks or take equal number of long and short positions in stock/index futures/options.

- **Explore Arbitrage Opportunities:** Category III AIFs seek to take the benefits of arbitrage from potential mispricing of related equity and/or debt securities. Convertible Bonds and Equity shares issued by the same company can be relatively mispriced in the short-term based on the Conversion Ratio offered to the bondholders.

- **Event-based Opportunities:** Category III AIFs also look to invest during corporate re-structuring events, to take benefits of short-term mispricing in equity or debt securities. Corporate re-structuring events, such as mergers, are useful to identify potential mispricing of equity shares of the acquiring company and the target company, based on the conversion ratio announced in the merger.

- **Investing at Higher Discounts:** Another common strategy deployed by Category III AIFs are to invest in pre-IPO deals, when a growth-stage company is about to file for an IPO. Before the IPO, the Category III AIF can invest up to 10 percent of its investable funds in the shares of the company which is proposed to get listed, with the intent of selling shares at a higher premium. However, such investments are subject to a minimum lock-in period of 6 months, as per SEBI (Issue of Capital and Disclosure Requirements) Regulations.

Investment Strategies of Category III AIFs is discussed in further detail, in Unit 7.

3.5 Comparison between Category III AIF and Traditional Investments

3.5.1 Category III AIFs Vs. Portfolio Management Services

Portfolio Management Services (PMS) offer customized investment advisory and portfolio management services to a potential client looking to invest a minimum amount of Rs.50 lakhs. Different investors have their own set of risk-return characteristics and constraints. A PMS aims at providing a tailor-made investment advisory and portfolio management service to these investors, having unique investment objectives.

PMS are offered individually to each investor or "client" of the portfolio manager. Hence, the investor "owns" every security purchased by the Portfolio Manager. This is different from investing in Category III AIFs, where the investors own "units" of the fund representing the underlying security. AIFs act as "pooling vehicles" and collectively invest funds on behalf of all the investors, which is not the case in PMS.

Market regulator SEBI has prescribed the regulatory framework, SEBI (Portfolio Managers) Regulations, governing PMS activities. Portfolio Management Services can be in the form of either a Discretionary PMS or a Non-Discretionary PMS. In a Discretionary PMS, the portfolio manager is empowered to take decisions on behalf of the investor; while in a Non-Discretionary PMS, the portfolio manager executes what the investor wants in terms of investments. Table 3.1 draws out the comparisons between PMS and Category III AIFs.

Table3.1: Comparison between PMS and Category III AIF

Particulars	**PMS**	**Category III AIF**
Pooling of funds	Pooling of investor funds is not done. Separate demat accounts are created for every investor. However, trading can be done at pool or individual client level.	Pooling of investor funds is compulsory, for collective investment. Trading is done only at pooled level.
Minimum Investment Amount	Rs. 50 lakhs	Rs. 1 crore[30] or Rs. 25 lakhs for employees of the AIF
Minimum Corpus	No minimum corpus amount required for starting PMS, even one client is good to start.	Category III AIF corpus to be minimum Rs. 20 crore.
Lock-in Period	PMS investors have the choice to withdraw funds at any time since the securities are in their own name.	Close-ended Category III AIF units have a lock-in period, whereas, open ended funds could allow investors to redeem monthly or earlier.
Number of Investors	There is no cap specified on the number of investors for PMS.	Maximum number of investors cannot exceed 1,000.
Manager Contribution or Networth Criteria	No requirements for manager contribution, however the manager needs to have a networth of Rs. 5 crores at all times.	For a Category III AIF, manager or sponsor should hold at least 5% of the corpus or Rs. 10 crores, whichever is lower;

[30] Not applicable to Accredited Investors.

Particulars	PMS	Category III AIF
		however, there are no networth criteria.

3.5.2 Category III AIFs vs. Mutual Funds

A mutual fund (MF) pools funds from multiple investors and invests them collectively in traditional assets like stocks and debt/bonds. Mutual Funds have a stated investment mandate and investment policy, as described by the Asset Management Company (AMC), managing the mutual fund. Every AMC is backed by a sponsor company, which also appoints the Trustee and Custodian for the fund and each scheme within the fund.

Unlike PMS, mutual fund services are offered collectively to investors and cannot be customized to the investment objectives of one investor. Retail Investors can also invest in mutual funds, with minimum amount being as low as Rs. 500 per investor.

Market regulator SEBI has prescribed the regulatory framework, SEBI (Mutual Fund) Regulations, governing mutual funds. Table 3.2 draws out the comparisons between Mutual Funds and Category III AIFs.

Table3.2: Comparison between Mutual Fund and Category III AIF

Particulars	Mutual Fund	Category III AIF
Sponsor/Manager	Sponsor is different from the Manager. Sponsor has to contribute 1% of the amount raised in a scheme or Rs. 50 lakhs, whichever is lower.	Manager and Sponsor can be the same entity. Sponsor or Manager should hold at least 5% of the corpus or Rs. 10 crore, whichever is lower.
Investment Strategy	Low-risk and medium-risk, depending on categorization of schemes. Leverage is not allowed.	Long only, long short, medium to high-risk strategy, with or without leverage.
Minimum Investment Amount	Rs. 500 or as specified in the scheme.	Rs. 1 crore[31] or Rs. 25 lakhs for employees of the AIF.
Minimum Corpus	No minimum corpus amount required for Mutual Funds.	Category III AIF corpus to be minimum Rs. 20 crores.

[31] Not applicable to Accredited Investors.

Particulars	Mutual Fund	Category III AIF
Lock-in Period	Investors have the choice to withdraw funds at any time (except tax funds or other close-ended funds where there is lock-in).	Close-ended Category III AIF units have a lock-in period, while open ended funds are available for investors to redeem at pre-determined frequency.
Number of Investors	There is no upper cap specified on the number of investors.	Maximum number of investors cannot exceed 1,000.
Issue Process	Public Issue	Private Placement
NAV Declaration	Daily	Daily or Monthly or Quarterly as specified in the offer documents.

3.6 Hedge Funds: Global Market Overview

Category III AIF investment strategies in India closely resemble investment strategies by Hedge Funds across the globe. These Funds are allowed to take complex investment decisions and dynamic positions across asset classes, with the use of leverage, credit default swaps, derivatives or short positions.

Global Hedge Funds take a risky approach to investing, with high leverage and concentrated positions. Investment Managers of large hedge funds like to venture out to invest in non-traditional assets, through the Fund. These assets may include Private Equity assets, Film Funds, Intellectual Property Rights, Wine Funds, Sport Leagues, Green Bonds, etc. Such assets are illiquid, with non-linear pay-offs and low correlations with traditional assets such as equities, fixed income securities and cash. Investment in non-traditional assets helps to diversify the fund portfolio and balance overall portfolio risk.

In the North American Markets, Fund of Funds (FoF) and Commodity Trading Advisors (CTAs) are very common, other than equity-based investment strategies. In the European markets, Multi-strategy Funds have got more traction apart from traditional equity-based strategies and fixed-income strategies.

Fund of Funds invest in other hedge funds, implementing different investment strategies. This gives the benefit of diversification, as the investment manager of the FoF is not relying on one investment strategy to generate returns for the investor. However, since the investment manager is investing in multiple funds, the fees charged by a FoF are substantially high as compared to single-strategy hedge funds. Fees increase due to management fees charged by every hedge fund and the additional layer of management fees charged by FoF manager.

Multi-strategy Funds, on the contrary, are hedge funds which deploy multiple investment strategies, within the same fund scheme. This gives the benefit of diversification as well as controls the pay-out of management fees, by investors.

Commodity Trading Advisors (CTAs) are registered with the local regulator, National Futures Association (NFA) in USA and follow a unique investment strategy known as "Managed Futures" strategy. CTAs generally deploy systematic or discretionary investment strategies, in commodity futures, equity futures as well as currency futures. Systematic Investment Strategies make use of complex algorithms to track the price movement of different asset classes, such as commodities, currencies and equities, in different geographies. Using the price inputs and pre-defined investment objectives, the algorithm is structured to take suitable exposures in the futures market across geographies. Discretionary Investment Strategies rely on the judgement and expertise of the investment manager to make the investment decision in the futures market. Managed Futures Strategy is commonly used to benefit from short-term mispricing among asset classes and derivative contracts.

Indian Category III AIFs are permitted by SEBI to invest in all commodity derivatives products that are being traded on the commodity derivatives exchanges. They can invest up to 10 percent of the investable funds in one underlying commodity, subject to the reporting requirements set forth by SEBI.[32]

Multi-strategy was the most common investment strategy among hedge funds worldwide, as of the first quarter of 2022. This strategy was implemented by approximately 27 percent of the hedge funds, while Equity-based strategies were implemented by approximately 24% of the hedge funds across the globe.[33]

Growth in Category III AIFs, with the help of regulatory reforms and increasing investor appetite for risks, can help investment managers explore diversified investments in the alternative investment space, such as systematic or discretionary managed futures in commodity/currency markets, film funds, Intellectual Property Rights, Wine Funds, Sport Leagues, Green Bonds and the like.

Category III AIF can increase portfolio diversification, given low correlations to traditional investments. These funds offer the potential for enhanced returns with a wider investment opportunity set.

[32] SEBI Circular No.: SEBI/HO/CDMRD/DMP/CIR/P/2017/61 dated June 21, 2017 on Participation of Category III Alternative Investment Funds (AIFs) in the commodity derivatives market and SEBI Circular No.: SEBI/HO/IMD/DF1/CIR/P/2017/110 dated September 29, 2017 on Change in reporting norms for Category III Alternative Investment Funds (AIFs) regarding investment in commodity derivatives market.

[33] Source: Published by Statista Research Department on July 26, 2022.

3.7 Category III AIF as a Risk Management tool

A Category III AIF should be able to identify the material risks for the fund and report to investors, in quarterly reports sent to investors, within 60 days of end of very quarter. 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, while risk-taking investors will seek to maximise their return at a given risk level. In order to achieve the risk-return 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 the excess return generated by the Category III AIF manager, over and above the return generated by its benchmark. "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, to buy under-priced securities and sell over-priced securities. With the development of technology, Category III AIF managers are using financial algorithms and machine learning techniques to identify mispriced securities and execute trades for the fund.

Alpha generation is the key to achieving superior return. However, there is a risk in making investment decisions, through active management, as the security prices can be impacted by broad-based market factors. For example, fear of a widespread disease in the country, or a war between two countries, can affect the global 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.

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. Category III AIFs can inherently have higher Beta, as compared to traditional asset classes, if the investment manager is investing in highly volatile assets. For example, if Fund ABC takes long positions primarily in small-cap and mid-cap securities, the overall portfolio Beta will be high, as compared to Fund XYZ which takes long positions in large-cap securities. This is due to the inherent risky nature of the underlying shares in which Fund ABC is investing. This risk cannot be diversified, by investing across industries, sectors and geographies.

Category III AIF investment manager is responsible to manage the systematic risk of the fund, commensurate with its investment strategy as stated in the Private Placement Memorandum. High beta investments are likely to outperform the benchmark during bull markets, but are also likely to underperform during bear markets. In our example of Fund ABC, which is investing in small-cap and mid-cap stocks, the investment manager should be more aggressive during bull markets, as compared to Fund XYZ.

Category III AIFs can be used by an Institutional Investor, for Alpha Generation as well as Beta Management. Let us consider this with the help of an example.

Example 2:

An Institutional Investor, XYZ Investments Ltd. is having a portfolio of investments, as under:

Particulars	**Allocation**
Large-cap Stocks – Across Industries	40%
Mid-cap Stocks – BFSI Industry	20%
Small-cap Stocks – Pharmaceutical Stocks	20%
Fixed Income Securities – Government Bonds	20%

The Investor is considering re-allocating half the funds invested in Large-cap Stocks (20% of the portfolio) to a Domestic Category III AIF, with the following investment strategy:

Particulars	Allocation
Net Long Positions in Large-cap Stocks – Across Industry	25%
Net Long Positions in Mid-cap Stocks – BFSI Industry	35%
Long Positions in Small-cap Growth Stocks – Pharmaceutical Stocks	30%
Money Market Instruments	10%

Should the investor consider the re-allocation? Does it help to improve the Alpha and Beta for the Investor?

Solution:

XYZ Investments Ltd. shall consider the reallocation of funds to the domestic Category III AIF, as it can potentially help to increase Alpha, provided it is within the acceptable level of systematic risk and the manager predicts a bull market in the near term.

As observed from the original portfolio, the investor was invested in mid-cap stocks in the BFSI industry and in small-cap stocks in the pharmaceuticals industry. Reallocation to the Category III AIF will undoubtedly increase the potential returns, as small-cap and mid-cap stocks generally provide a higher return when compared to large-cap stocks in a bullish market. Moreover, the mid-cap stock allocation as well as the small-cap stock allocation targeted by the Category III AIF is also in the same industry in which the investor is previously invested. This will not substantially impact the overall portfolio beta, ignoring the benefits of diversification.

Chapter 3: Sample Questions

1. **Which of the following types of investors would least likely to invest in a Category III AIF?**

    a. Public Pension Funds
    b. **Risk-averse Retail Investors**
    c. Insurance Companies
    d. Sovereign Wealth Funds

2. **As per the SEBI (Alternative Investment Funds) Regulations, 2012, the Sponsor or Manager of a Category III AIF shall have a minimum capital commitment of: ______________**

    a. 1% of the amount raised in a scheme or Rs. 50 lakhs, whichever is lower.
    b. **5% of the corpus or Rs. 10 crores, whichever is lower.**
    c. 2.5% of the corpus or Rs. 5 crores, whichever is lower.
    d. No minimum capital commitment required.

3. **What fees is charged to investors, on redemptions made after completion of the lock-in period but before the expiration of stated fund tenure?**

    a. **Exit Load**
    b. Incentive Fee
    c. Redemption Gate
    d. Hurdle Rate

4. **Which of the types of fees is charged by Investment Managers for maximising the return for investors in the Category III AIF?**

    a. Exit Load
    b. High Water Mark
    c. Management Fees
    d. **Performance Fees**

5. **Managers of AIFs prefer to include a catch-up clause in the Contribution Agreement, with a high catch-up rate. State whether True or False.**

    a. **True**
    b. False

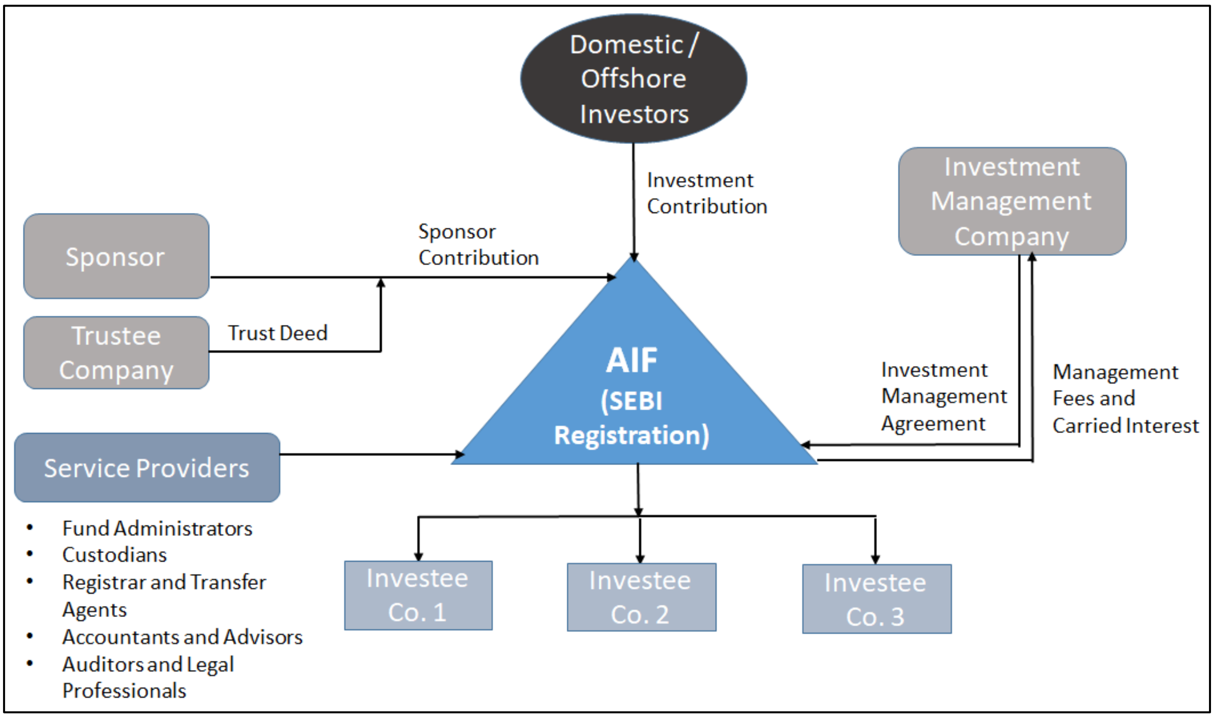
Chapter 4: Category III AIF: Fund Structures and Service Providers

LEARNING OBJECTIVES:
After studying this chapter, you should know about: • Fund structures of a Category III AIFs (On-shore & Off-shore/ Unified & Co-investments/ Parallel & Master Feeder) • Roles of various service providers in Category III AIF industry (Fund Administrators/ Distributors/ Registrar & Transfer Agents/ Tax Advisors/ Custodians/ Legal Advisors/ Investment Advisors) • Documentations done for Category III AIFs at On-shore and Off-shore Levels

4.1 Fund structures of a Category III AIF

As per the SEBI (Alternative Investment Funds) Regulations, a Category III AIF can be registered as a Trust or a Company or a Limited Liability Partnership (LLP) or a Body Corporate. Figure 4.1 shows the Category III AIF structure.

Figure 4.1: Fund Structure of Category III AIF



As seen in Figure 4.1 above, the Category III AIF is formed by a Sponsor, with a minimum contribution and adequate skin-in-the-game[34]. The Sponsor appoints the Trustee by signing the Trust Deed and the Manager by signing the Investment Management Agreement, to form part of the Category III AIF. If a Category III 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 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 Investment 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 and Financial Advisors etc.

In a limited liability partnership structure (LLP), the sponsor of the Category III AIF 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).

As per SEBI (Alternative Investment Funds) Regulations, a Category III AIF can be structured either as an open-ended fund or a closed-ended fund.

Open-ended Fund Structure:

In an Open-ended fund structure, investors contribute capital at the time of subscription. The open-ended schemes offer units to investors on a continuous basis and do not have a fixed maturity period. Hence, investors can buy units or sell units from the AIF at any time, thereby making the corpus of the fund variable. Open-ended schemes permit investors to redeem capital at regular intervals, viz. monthly, quarterly or semi-annually.

Closed-ended Fund Structure:

Closed-ended funds are offered to investors for a limited time period, as specified by the Investment Manager of the fund, in the Placement Memorandum. Closed-ended funds require investors to make a capital commitment from time to time, within the specified commitment period. Commitment periods for closed-end funds typically range from 3-5 years

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

from the final closing date. Closed-end funds do not permit redemptions of capital at any time prior to the expiration of the fund, except in extraordinary circumstances. Most Category III AIFs in industry would have a lock-in period of 1-2 years, post which investors would be permitted to redeem their capital by paying an exit load, for redemption/exits between periods of 2-3 years from the completion of the lock-in period.

Example: A Category III AIF launches a closed-ended scheme for 5 years, with an option given to investors to exit from the scheme after expiry of a lock in period of 2 years, by paying an Exit Load. For exits made after the completion of lock-in period, till the end of the fund tenure, exit load will be paid by the investor, as per the Redemption Gates specified by the Manager in the Private Placement Memorandum.

4.1.1 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.

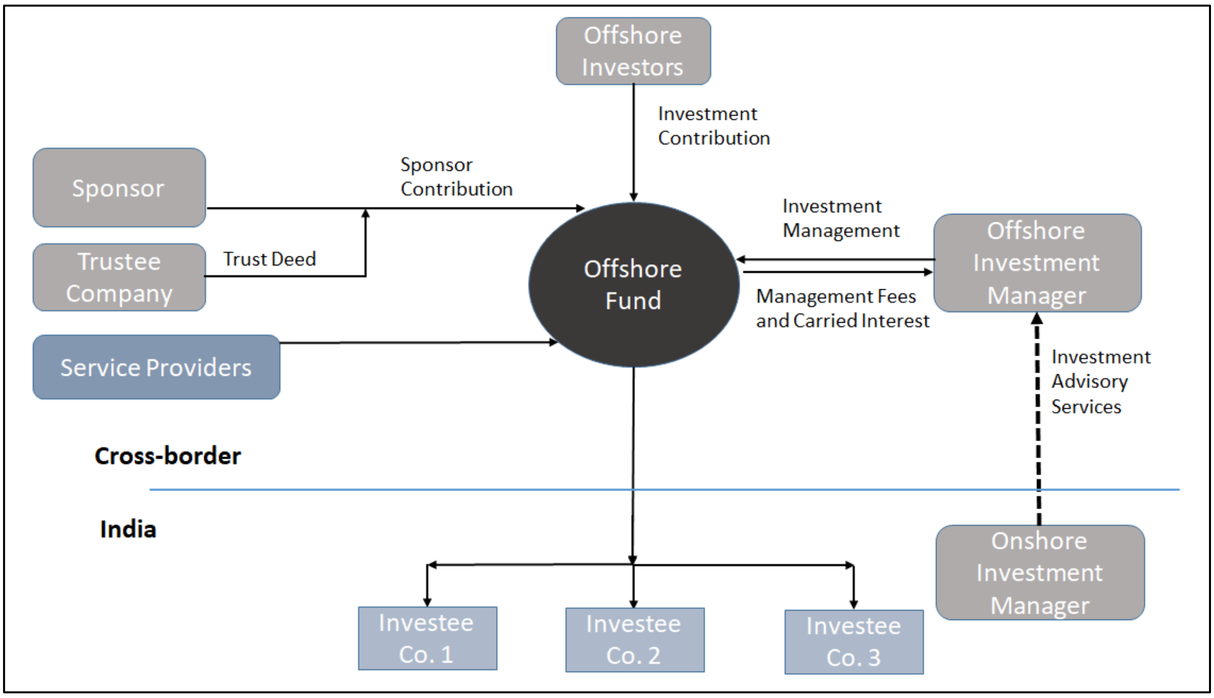
Offshore Funds and Investors: India follows source-based taxation on capital gains. Accordingly, offshore fund structures are used for offshore investors to invest into India to avoid double taxation on the same income stream. Offshore Funds are formed in countries which have Bilateral Investment Promotion 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 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 4.2 graphically represents the offshore fund structure.

Figure 4.2: 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.

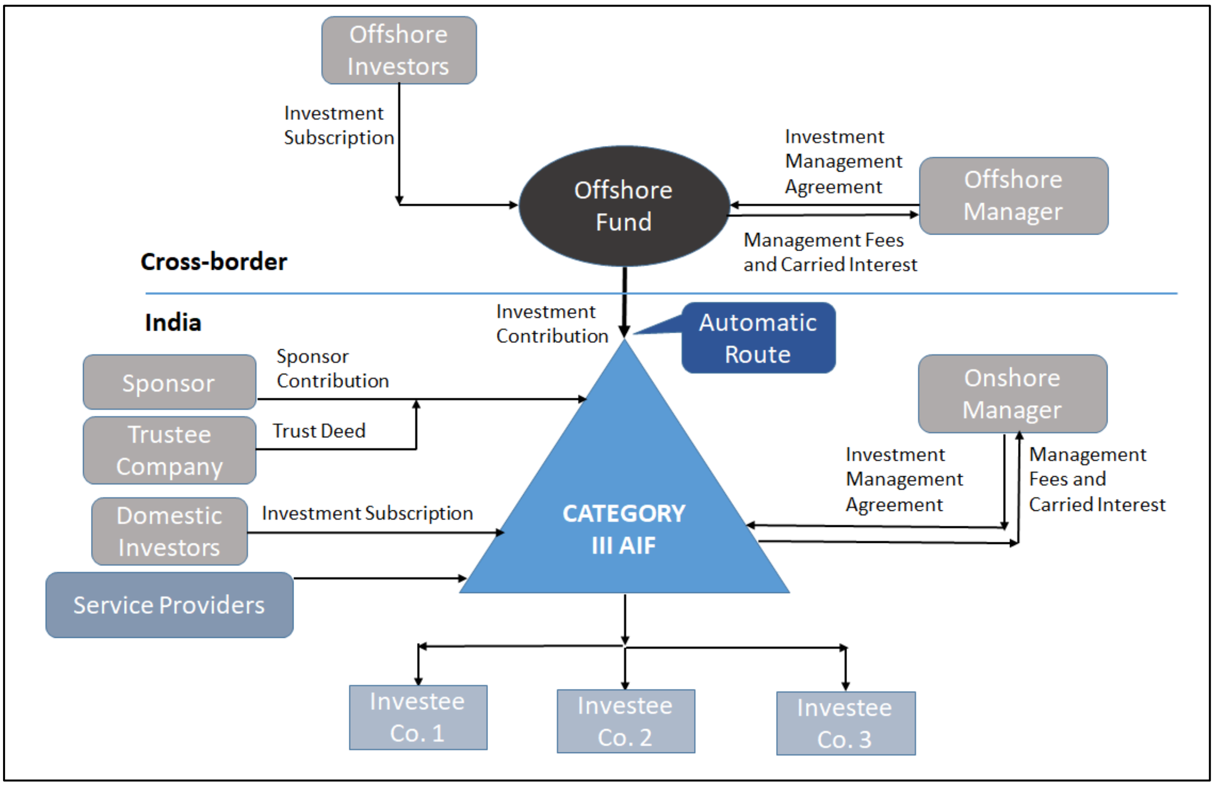
On-shore Funds shall seek registration under SEBI (Alternative Investment Funds) Regulations and file the Private Placement Memorandum (PPM) with SEBI through a merchant banker, in the prescribed format for their observations. Figure 4.1 depicted earlier is a typical onshore fund structure.

4.1.2 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 Foreign

Investment Promotion Board (FIPB), for Foreign Portfolio Investors (FPI) to invest in the unified structure. General permission has been granted in accordance with the Foreign Direct Investment (FDI) Policy to accept foreign investments under the automatic route. Figure 4.3 represents the Unified Fund Structure.

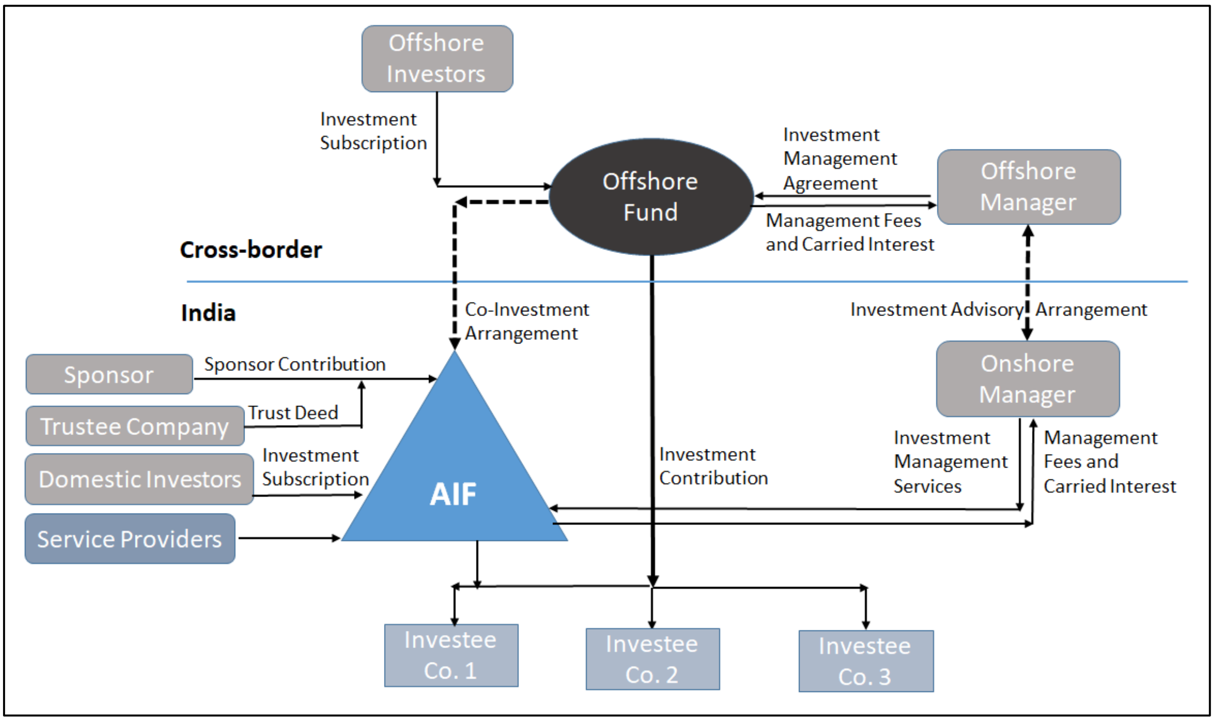
Figure 4.3: Unified Fund Structure



As seen from Figure 4.3, 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 Category III AIF, registered in India with SEBI. The Category III 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 Category III 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 4.4 represents the Co-investment Fund Structure.

Figure 4.4: Co-investment Fund Structure



As seen from Figure 4.4, the Offshore Fund is directly investing in investee companies or target securities of the domestic Category III AIF, registered in India with SEBI. The Onshore Fund and the Offshore Fund both have their investors, who have 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. 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.

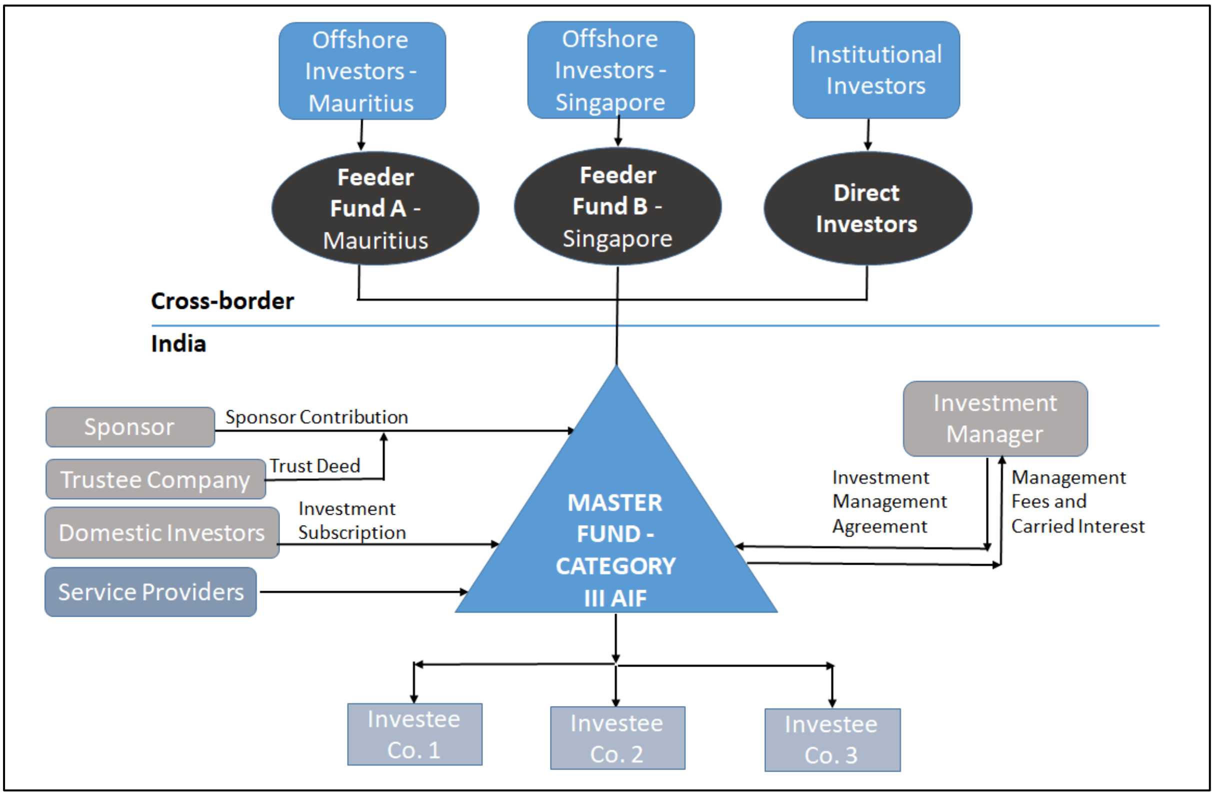
4.1.3 Master Feeder Structure and Parallel Structure

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.

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 in that jurisdiction. Figure 4.5 below shows the Master Feeder Structure.

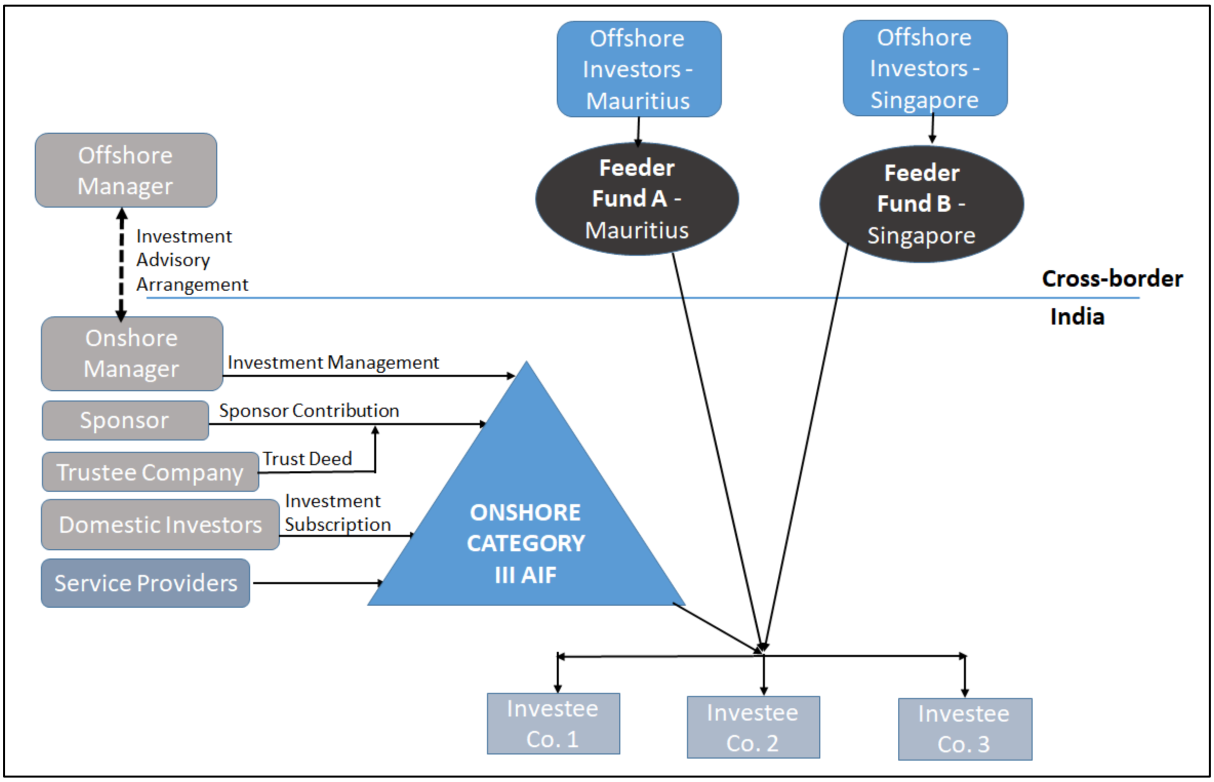
Figure 4.5: Master-Feeder Structure



As seen in Figure 4.5 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 management fee charged by the master fund is passed on to the feeder fund managers, based on mutual understanding, 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 invests through separate feeder fund(s) in each jurisdiction. These Feeder Funds then invests 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 (HNIs) 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 Category III AIF in India, like in a Master-feeder structure. Figure 4.6 represents the Parallel Structure.

Figure 4.6: Parallel Structure



As seen in Figure 4.6 above, the Feeder Funds in Mauritius and Singapore are investing directly in investee companies in India, along-side the Onshore Category III AIF. Since Feeder Funds make independent investment decisions, the Investment Manager of the Category III 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 Category III AIFs may be expensive, as compared to the Master Feeder Structure. However, using a Parallel Structure, institutional investors and HNIs 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 might be placed in a separate one.

4.2 Service Providers in the Category III AIF industry

Category III 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. Category III AIF, thus, appoints various service providers for other activities related to the fund. These service providers are as follows:

4.2.1 Merchant Bankers

Merchant bankers are appointed by the fund to perform various activities related to launch of schemes. Category III 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.[35]

As per SEBI (Alternative Investment Funds) 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.
- 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.

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

4.2.2 Registrar and Transfer Agents

Subscriptions and redemptions made by different class of unit holders must be accounted for, by the Category III 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.[36] 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.[37] Therefore, appointment of RTAs by a Category III AIF is made compulsory to enable collection of applicable stamp duty.

4.2.3 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 Category III 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.

All custodians need to register with SEBI under the SEBI (Custodian) Regulations 1996. As per SEBI (Alternative Investment Funds) Regulations, the Sponsors or Managers of Category III AIFs should compulsorily appoint a custodian, irrespective of the size of corpus of the Fund, for safekeeping of securities as well goods received in delivery against physical settlement of commodity derivatives.[38] In the case of Category III AIFs registered as trusts, the custodian is appointed by the trustees. A custodial agreement is entered into between the trustees and the custodian. 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.

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[36] The 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.

[37] SEBI 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.

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

4.2.4 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
- 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
- Co-ordinating company secretarial matters, including documentation for board and shareholder meetings
- Preparing and distributing investment manager statements, interim financial reports and annual reports
- Providing necessary support to fund auditors

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.

4.2.5 Fund Infrastructure

Category III AIFs depend on robust platforms and software for trade execution. Speed of trade execution is critical for the success for investors and investment managers. Trading Platforms, used internally by the Category III AIF or outsourced to third-party vendors, help Managers get real-time data on fund-level and firm-level positions, client accounts and related fees. 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.

The most common systems used in a Category III AIF are Order Management Systems (OMS), a real time price terminal, other databases for fundamental analysis like Bloomberg, Reuters, etc.

4.2.6 Distributors and Placement Agents

One of the key developments that would shape the growth and proliferation of the Category III 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 Category III AIF products, services, investment strategies and their return potential.

A distributor can be empanelled with more than one Category III AIF. Distributors can be individuals or institutions such as distribution companies, broking companies and banks. However, Category III AIF 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 Category III 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 Category III AIFs, for their investors/clients on a case-to-case basis. They should have a complete understanding of the operations of a Category III 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.

4.2.7 Tax Advisors

Tax Advisors are appointed by Category III AIF managers to get advice on domiciling the funds. Offshore Funds, in tax-friendly jurisdictions, have proved to be beneficial for investors and avoid cascading effects of taxation for Category III AIFs. Tax Advisors also serve investors, typically foreign portfolio investors, in deal structuring, tax compliance and due diligence, when they look to invest in domestic Category III AIF market or related securities.

4.2.8 Legal Advisors

Drafting of legal agreements and legal documentation is done by third-party legal advisors or in-house legal counsels appointed by the Category III 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 Category III AIF. Some of the documentation work done by legal counsels is underlined below:

- **Private Placement Memorandum (PPM):** The PPM is the offer document made by the Category III AIF, both at Onshore Level and Offshore Level to attract capital commitments from potential investors. The PPM should contain all material information about the Fund, such as:
    - Background of key investment team of the Investment Manager
    - Targeted investors and geographies, whether Offshore, Onshore or both
    - Class of units to be issued to investors
    - Terms and conditions on which the Manager offers investment services, its affiliations with other intermediaries
    - Fees and all other fund expenses proposed to be charged
    - Tenure of the Category III AIF or the Fund scheme
    - Conditions and limits on redemption, exit load to be paid and redemption gates
    - Investment strategy, risk management tools and parameters employed
    - Key service providers, potential conflict of interest, procedures to identify and address them
    - Potential conflict of interests of the investment manager, with the Category III AIF, its affiliates and subsidiaries.
    - Legal and Regulatory Norms applicable to the fund
    - Valuation Policy and mechanisms followed for computation of NAV
    - Computation of High-Water Mark and Additional Returns for the fund
    - Disciplinary history of the Sponsor and Manager of the fund
    - Dispute Redressal Mechanism adopted by the fund
    - Manner of winding up of the Category III AIF or the scheme
    - Terms of reference of the committee constituted for approving the decisions of the AIF[39]
    - Such other information as may be necessary for the investor to take an informed decision on whether to invest in the Category III AIF

To ensure that a minimum standard of disclosure is made available in the PPM, SEBI has provided a template for the PPM, and made it mandatory for Category III AIFs to provide the minimum level of information, as required by their format. Category III AIFs are also permitted

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

to provide additional information in their PPM. **Documentation done for Category III Fund at Onshore Level:**

- **Investment Management Agreement**: This agreement is made for the fund's trustee to appoint the investment manager and delegate all its management powers in respect of the fund to the investment manager, except for certain retained powers that are identified in the Indenture of Trust.

- **Indenture of Trust:** Most Category III AIFs in India are formed as "Trust" registered under Indian Trusts Act, 1882 to enjoy tax benefits provided under the Income Tax, 1961.This document ascertains the nature of the Trust, whether it is "determinate" or "indeterminate". Trusts are considered to be "determinate" if the individual shares of the beneficiaries are expressly stated in the trust deed and are identifiable and ascertainable as on the date of the trust deed. In case of an "indeterminate trust", the trust is treated as an 'association of persons' and tax is charged on the entire income of the trust at the maximum marginal rate.

- **Contribution Agreement**: This Agreement records the terms on which an investor participates in a fund. It includes aspects relating to computation of beneficial interest, distribution mechanism, list of expenses to be borne by the fund, powers of the investment committee, capital drawdown mechanism, among others.

- **Investor Side Letters:** Some large investors may ask for certain exemptions or preferential treatment, by the investment manager. These requests are recorded in the Investor Side Letters. Investors seek differential arrangements with respect to reduced management fee and participation in investment committees, among others.

  It is important to note that the investment manager of a Category III AIF 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.

Documentation done for Category III Fund at Offshore Level:

- **Subscription Agreement:** This agreement sets out the terms and conditions on which an investor will subscribe to the securities issued by an offshore fund. The agreement sets out the investor's capital commitment to the fund and also records the representations and warranties made by the investors, such as the investor being qualified under law and declared as "fit and proper" to make investments in the fund.

- **Advisory Agreement:** 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 advise in respect of the transactions for the Fund's board.

- **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.

4.2.9 Auditors

Statutory auditors and Independent financial auditors are compulsorily appointed by Category III AIFs as they sign-off on the financial statements. All the books of accounts of the AIF shall be audited annually by a qualified auditor.

It is mandatory for all Category III AIFs to perform a yearly audit at the end of each financial year to ensure compliance of terms of the PPM. Such audit is to be conducted through internal or external auditors or legal professionals. The findings of such audit, along-with corrective steps to be taken if any, must be communicated to the Trustee or Board or Designated Partners of the Category III AIF, Board of the Investment Managers and SEBI, within 6 months from the end of the financial year. Audit of sections of PPM relating to 'Risk Factors', 'Legal, Regulatory and Tax Considerations' and 'Track Record of First Time Managers' shall be optional.

However, such audit requirements may not apply for AIFs:

(a) Large Value Funds, in which each investor commits to a minimum capital contribution of Rs. 70 crores (USD 10 million or equivalent, in case of capital commitment in non-INR currency)

(b) which have not raised any funds from their investors and are required to submit a Certificate from a Chartered Accountant in this regard, within 6 months from the end of financial year.[40]

[40] SEBI Circular Nos.: SEBI/HO/IMD/DF6/CIR/P/2020/24 dated February 5, 2020 and SEBI/HO/IMD/DF6/CIR/P/2020/99 dated June 12, 2020 on Disclosure standards for Alternative Investment Funds (AIFs) and its clarifications respectively.

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 III AIF, if any, 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 III 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 III 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 III AIF
- Ensure that the Category III 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
- 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

4.2.10 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.

Chapter 4: Sample Questions

1. **Which of the following entities can least likely be a Service Provider for a Category III AIF?**

    a. Auditors
    b. Custodians
    c. Fund Administrators
    d. **Sponsor**

2. **The agreement prepared by legal advisors, wherein the trustee appoints the manager of the Category III AIF, is known as _____________.**

    a. Investor Side Letter
    b. **Investment Management Agreement**
    c. Contribution Agreement
    d. Advisory Agreement

3. **In a _____________ Structure, commitments from both domestic and offshore investors are pooled into a domestic pooling vehicle and no approval is required from the Foreign Investment Promotion Board, to raise capital from foreign investors.**

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

4. **In which fund structure can a feeder fund invest directly in investee companies in India, along-side an Onshore Category III AIF?**

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

5. **Distributors can be individuals or institutions and can be empanelled with more than one Category III AIF. State whether True or False.**

    a. **True**
    b. False

Chapter 5: Regulatory Framework

LEARNING OBJECTIVES:

After studying this chapter, you should know about:

- SEBI (AIF) Regulations, 2012
- SEBI (PIT) Regulations, 2015
- Prevention of Money Laundering Act, 2002
- Foreign Exchange and Management Act, 1999
- SEBI (ICDR) Regulations, 2018
- Various reporting requirements under SEBI, FATCA and CRS

5.1 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 impact funds, special situation 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 Rs. 1 lakh. Such penalty may extend up to Rs. 1 lakh for each day of non-compliance with regulations, subject to a maximum of Rs. 1 crore or three times the amount of gains made out of such non-compliance, whichever is higher.[41]

5.2 Registration of a Category III Alternative Investment Fund

SEBI (Alternative Investment Funds) Regulations mandates all alternative investment funds to register with SEBI and obtain a certificate of registration. Such certificate is compulsory to carry out alternative investment activities in India. Any unregistered AIF will not be permitted to carry out alternative investment activities.

All Funds registered with SEBI, as “venture capital funds” under SEBI (Venture Capital Funds) Regulations, 1996 shall continue to be regulated under the said regulations till such funds have been wound-up and such funds shall not launch new schemes. Also, such Funds shall not be allowed to increase their target corpus or total committed capital. However, these

[41]Vide Section 15EA of SEBI Act, 1992.

funds may seek re-registration under SEBI (Alternative Investment Funds) Regulations by getting approval from two-thirds of the investors in the fund, by value of their investment.

Any AIFs in existence before implementation of SEBI (Alternative Investment Funds) Regulations was given a six-month time period, from the date of commencement of these Regulations, to be registered with SEBI under the SEBI (Alternative Investment Funds) Regulations. Such existing funds shall be allowed to complete their tenure without raising any fresh capital from investors, other than the commitments already made. Those existing funds which do not propose to accept any fresh commitments after commencement of SEBI (Alternative Investment Funds) Regulations were not required to obtain registration certificate under the said regulations.

5.2.1 Registration Process

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

2. **Category II Alternative Investment Fund –** Such type of funds is prohibited from taking leverage or borrowing, except to meet day-to-day operational requirements of the Fund. 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. Corporate Debt

Market Development Fund is a type of specified AIF, as provided under Regulation 19 of SEBI (AIF) Regulations, 2012.[42]

The permissible legal structures of an entity, seeking registration as a Category III AIF 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.

To seek registration as a Category III AIF, an application must be submitted in the prescribed format, accompanied with non-refundable application fees of Rs. 1 lakh for launching the investment scheme, and registration fees of Rs. 15 lakhs for approval of registration with SEBI.

The applicant is required to submit the following details to SEBI along-with the application:

- General Information such as Name of Firm, Registered Address, Contact Details, Legal Structure and Date of Incorporation
- Fund Structure, AIF Category, Type of Fund (open-ended or closed-ended) and proposed Fund Infrastructure
- Private Placement Memorandum (PPM)
- Applicant Details, Investment Manager Details and Sponsor Details, along-with supporting documents
- Business Plan and Investment Strategy
- Past Legal and Regulatory Actions taken, if any
- Any other Information and/or declaration, as necessary

5.2.2 Eligibility Criteria

SEBI shall consider the following factors, before granting registration to the applicant of a Category III AIF:

- Legal and Formation Documents of the applicant entity: Memorandum of association (MoA) in case of a Company; or Trust Deed in case of a Trust; or Partnership deed in case of a Limited Liability Partnership (LLP) shall permit the applicant to carry on the activity of an AIF.

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

- The applicant, whether a Trust or Company or LLP, shall be prohibited from making an invitation to the public for subscription of securities, by their respective legal documents.

- Registration of the Legal Documents is compulsory for every applicant. For example:
    - In case of a Company, MoA shall permit the entity to carry on alternative investment activities and the corporate entity shall be in compliance with all the central and state laws.
  - In case of a Trust, the trust deed must be duly formed and registered as per the provisions of the Registration Act, 1908
  - In case of an LLP, the partnership must be incorporated under a partnership deed and filed with the Registrar as per the provisions of the Limited Liability Partnership Act, 2008
  - In case of a Body Corporate, the entity must be set up or established under the laws of the Central or State Legislature and shall be permitted to carry on alternative investment activities.

- The Applicant, including its Sponsor and Manager, should be "fit and proper" as defined in Schedule II of SEBI (Intermediaries) Regulations, 2008.

- The Key Investment Team of the Manager of the AIF shall fulfil the following criteria:[43]
  - 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 in to ensure compliance with certification norms.[44]
  - At least one key personnel shall have a professional qualification in finance, accountancy, business management, commerce, economics, capital market or banking from a university or an institution recognised by Central Government or any State Government or a foreign university, or a CFA charter from the CFA Institute or any other qualification as may be specified by SEBI.

It is to be further noted that both the requirements stated above, may also be fulfilled by the same key personnel in the key investment team.

- The Manager or Sponsor shall have the necessary manpower and infrastructure to perform activities as an alternative investment fund.

- The Applicant shall clearly state its Investment Objectives, Targeted Investors, Proposed Corpus, Investment Style or Investment Strategy and proposed Tenure of the Fund while submitting the application for registration.

- The Applicant, including its Sponsor and Manager, must mention any previous history of refusal of Registration by SEBI.

[43]Vide SEBI (AIF) (Amendment) Regulations, 2020 w.e.f. October 19, 2020.

[44] Vide SEBI (AIF) (Second Amendment) Regulations, 2023 dated June 15, 2023, effective on such date as SEBI may notify in the Official Gazette.

5.2.3 Disclosure Requirements

The applicant of a Category III AIF shall submit all necessary information to SEBI which is helpful for granting the Registration Certificate. In case of a Category III AIF, the Sponsor or Manager of the Fund shall compulsorily appoint a Custodian, irrespective of the size of corpus of the Fund and provide details to SEBI at the time of Registration.

A Category III AIF submits 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, on behalf of Category III AIF ○ Legal Structure of Applicant – Body Corporate or LLP or Trust or Company with Date and Place of Incorporation ○ Category III to be mentioned, 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 Category III AIF ▪ 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

Disclosure	Particulars
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 Category III 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 Category III 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 ○ 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

Disclosure	Particulars
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 ○ Details of proposed use of leverage for the Category III AIF
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:

Disclosure	Particulars
	○ They are "fit and proper" persons ○ They will contribute the required committed capital to fulfil the Sponsor Contribution in the Category III AIF i.e. they will contribute 5percent of the corpus of the Fund or Rs.10crore, whichever is lower. ○ They will comply with the General Investment Conditions and Restrictions applicable to Category III 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.

5.2.4 Grant of Certificate of Registration

On receiving information and disclosures made by the applicant, SEBI takes into account necessary requirements as per the SEBI (Alternative Investment Funds) Regulations, for granting Registration Certificate to the applicant.

The Registration Certificate is granted by SEBI, for the specific Category of AIF applied for by the applicant. Such Registration of the Fund is valid till the AIF is wound up. The Registration may be granted with or without pre-specified conditions, by SEBI.

***In-Principle Approval* for a Category III 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 Category III 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.

5.2.5 Conditions for Registration of a Category III AIF

The Registration Certificate granted is subject to the following conditions:

- The Category III AIF shall comply with all the provisions of the SEBI (Alternative Investment Funds) Regulations.
- The Category III AIF shall carry out only the permitted activities in alternative investments.
- The Category III AIF shall inform SEBI in case of any previously submitted information is found to be false or misleading in a material manner, or if there is a material change in the information previously submitted.
- Registration granted to an AIF under a particular category cannot change its category subsequent to registration, without the approval of SEBI.

5.2.6 Refusal of Registration of a Category III AIF

SEBI may reject an application of Registration under the SEBI (Alternative Investment Funds) Regulations, after giving a reasonable opportunity of being heard, to the applicant. Such decision of refusal of registration shall be communicated within 30 days, to the applicant. After receipt of such communication, the applicant shall cease to carry on the activities as a Category III AIF, however, the liability of the applicant towards its existing investors under law or agreement shall not be affected.

5.3 Accredited Investors, Accreditation Agencies and the Accredited Investor Framework[45]

'Accredited Investors' means any person who is granted a certificate of accreditation by an accreditation agency, based on the following eligibility criteria:

Individual, Hindu Undivided Family (HUF), Family Trust, Sole Proprietorship or Partnership:

- Eligibility Criteria for accreditation is as follows:
  - annual income should be at least Rs. 2 crore; or
  - net worth should be at least Rs. 7.50 crore, out of which not less than Rs. 3.75 crores should be in the form of financial assets; or
  - annual income should be at least Rs. 1 crore and minimum net worth to be Rs. 5 crore, out of which not less than Rs. 2.50 crore should be in the form of financial assets

[45] Inserted by the SEBI (Alternative Investment Funds) (Third Amendment) Regulations, 2021

- 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 1 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.

- 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.

Body Corporates and Trusts:

- In case of a body corporate, net worth is at least Rs. 50 crore
  - Net Worth = (Capital + Free Reserves) – (Accumulated Losses + Deferred Expenditure not written-off)

- In case of a trust, other than a family trust, net worth is at least Rs. 50 crore
  - Net Worth = (Book Value of all Assets, other than intangible assets) – (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

The following entities are deemed as Accredited Investors and may not be required to obtain a certificate of accreditation by an accreditation agency:

- 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 the 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 the Board from time to time

"Large Value Fund for Accredited Investors" is 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 Rs. 70 crore.

'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 shall submit their applications to the Accreditation Agency.[46] 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.

The Accreditation Agencies should have the requisite infrastructure including systems and manpower to fulfil their responsibilities. 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 end date. The accreditation shall be valid for a period of 1 year, 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 three preceding financial years, the accreditation shall be valid for a period of 2 years, from the date of such accreditation.

The Accreditation Agencies shall be 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

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 (Alternative Investment Funds) Regulations, by submitting a copy of their Accreditation Certificate and an undertaking to Category III AIFs, to the effect that:

- The Accredited Investor wishes to avail the benefits under the Accredited Investor framework (AI Framework) and provides "Consent"

[46] Detailed documentation to be provided for accreditation is mentioned in Annexure B of SEBI Circular No.: SEBI/HO/IMD/IMD-I/DF9/P/CIR/2021/620 dated August 26, 2021. Link for the circular is as follows: https://www.sebi.gov.in/legal/circulars/aug-2021/circular-on-modalities-for-implementation-of-the-framework-for-accredited-investors_52116.html

- 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 a Category III AIF and the risks associated with it
- The Accredited Investor is aware that the units offered by a Category III AIF 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

A Category III AIF is responsible to independently verify the status of accreditation of a prospective investor, from the concerned Accreditation Agency. A Category III AIF 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, a Category III 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 Category III AIF must provide the following information:

- The details of regulatory concessions agreed upon, between the Category III 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 in to by a Category III 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 stipulated as 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 and before the expiry of the client agreement, the investments made by such investor shall be “grandfathered” and 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 in accordance with the SEBI (Alternative Investment Funds) Regulations.
- The Accredited Investors investing in “Large Value Fund for Accredited Investors” or any Category III AIF launched exclusively for the investor in which regulatory concessions have been availed, shall not be eligible to withdraw the Consent.

5.4 Conditions for investment in a Category III AIF

Every Alternative Investment Fund is formed with a specific Investment Strategy, Investment purpose and an Investment methodology. Category III AIFs are formed for the purpose of generating 'alpha', by implementing diversified investment strategies, across different asset classes. Such Strategy may involve additional use of Leverage, as per the SEBI (Alternative Investment Funds) Regulations, and may also involve the use of Derivative contracts. The investment process and methodology of a Category III AIF is decided by the Investment Manager, which states the frequency of calling capital from investors, investment limits and targeted securities/contracts for investment purpose.

As per SEBI (Alternative Investment Funds) Regulations, all Category III AIFs shall disclose the Investment Strategy, Investment Objective and the Investment Methodology to the potential investors, in their Private Placement Memorandum. Such Investment Strategy shall be applicable for the entire fund-life and all investments shall be made in accordance with the specified Investment Strategy. If there is a need for change in the Investment Strategy at any given stage in future, the Investment Manager shall seek approval of minimum two-thirds of investors, by value of their investments made in the Category III AIF.

SEBI (Alternative Investment Funds) Regulations states that a registered Category III 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 a Category III AIF shall ensure that:[47]

1. 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.

2. 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.

3. Any foreign investment fund, along with its underlying investors contributing minimum 25 percent of the fund corpus or having 'control' in the fund, shall not be mentioned in the Sanctions List notified by the United Nations Security Council (UNSC).[48] Further, such fund or any underlying investors should not be a resident of a country identified in the public statement of Financial Action Task Force (FATF) as:

[47] SEBI Circular No.: SEBI/HO/AFD-1/PoD/P/CIR/2022/171 dated December 9, 2022 on Foreign investment in AIFs.

[48] "Control" includes 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

- 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 Category III 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 again meet the said conditions. The same shall apply to investors already on-boarded to existing schemes of Category III AIFs.

All Category III AIFs should comply with the following investment conditions or restrictions:

- AIFs must issue units in dematerialise form, subject to conditions specified by SEBI.[49]
- Every Category III AIF, and all schemes launched by the Fund, must have a minimum corpus of Rs. 20 crore. SEBI has further clarified that if the corpus of an open-ended scheme of a Category III AIF falls below minimum corpus amount of Rs. 20 crore:[50]

    - The Category III AIF shall take necessary action to bring back the scheme size to Rs. 20 crore, within 3 months from the date of such breach.

    - The Category III AIF shall intimate to SEBI within 2 days of receiving request for redemption from the client, which results in the breach.

    - In case the Category III AIF fails to bring back the corpus within the prescribed period, it shall redeem entire units of all investors

    - In case of repeated violations by the particular Category III AIF, SEBI may take appropriate action against the Fund.

- Minimum investment by an investor in the Category III AIF shall be Rs. 1 crore.[51] In case investors are employees/directors of the Category III AIF or employees/directors of the Investment Manager of the Category III AIF, the minimum amount of investment from such investors shall be Rs. 25 lakh.

- An AIF can accept the following investors as joint investors:
    - an investor and his/her spouse
    - an investor and his/her parent

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virtue of shareholding or management rights or shareholders agreements or voting agreements or in any other manner.

[49] SEBI Circular No.: SEBI/HO/AFD/PoD1/CIR/2023/96 dated June 21, 2023 on Issuance of units of AIFs in dematerialised form.

[50] SEBI Circular No.: CIR/IMD/DF/14/2014 dated June 19, 2014 on Guidelines on disclosures, reporting and clarifications under AIF Regulations.

[51] Not applicable to Accredited Investors, as per SEBI (Alternative Investment Funds) (Third Amendment) Regulations, 2021

- 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 Rs. 1 crore[52] shall apply.[53]

- Category III AIFs must only raise capital by way of "private placement" mechanism. This prohibits the Fund from inviting general public to invest in the Fund.

- The Investment Manager or the Sponsor of every Category III AIF shall have sufficient skin-in-the-game and a continuing interest of at least 5 percent of the fund corpus or Rs. 10 crore, whichever is lower.

- The Investment Manager or the Sponsor of every Category III AIF shall disclose their investment and continuing interest in the Fund, to all other investors.

- Every scheme launched by the Category III AIF shall have a maximum of 1000 investors participating in the scheme.

- A Category III AIF may excuse or exclude its investor from participating in a particular investment in the following circumstances:[54]
  - 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 Category III 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.

[52] Not applicable to Accredited Investors, as per SEBI (Alternative Investment Funds) (Third Amendment) Regulations, 2021

[53] SEBI Circular No.: CIR/IMD/DF/14/2014 dated June 19, 2014 on Guidelines on disclosures, reporting and clarifications under AIF Regulations.

[54] 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.

5.5 Private Placement Memorandum

The Private Placement Memorandum (PPM) is akin to an Offer Document detailing all the important information related to the Category III 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 a Category III AIF, as per their risk-return objective. For a Category III AIF looking to raise capital commitments, the PPM is the most important and informative document as it provides all necessary information required by sophisticated investors, which is not generally available in the public, to take informed investment decisions.

As per the SEBI (Alternative Investment Funds) Regulations, the Investment Manager or Sponsor must launch AIF Schemes after filing the PPM with SEBI, through a SEBI registered Merchant Banker, at least thirty days prior to launch of scheme, along with payment of scheme fee of Rs. 1 lakh.[55] The application fee will not be applicable in case of a launch of the first scheme by the Category III AIF.

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.[56] 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.

Category III 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. Such intimation shall also be submitted through a Merchant Banker, along with the due diligence certificate.

Large Value Funds 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 PPM for Large Value Fund schemes are filed with SEBI along with a duly signed and stamped undertaking by CEO and Compliance Officer of the Manager to the Category III AIF in SEBI prescribed format.[57]

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[55] Not applicable for Large Value Fund of Accredited Investors

[56] SEBI 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.

[57] 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.

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.*"

In an effort to standardize the format of the PPM for registered AIFs, SEBI has issued a circular which provides a template for submitting information in the PPM, by a Category III AIF.[58] Annexure 2 to this circular provides the common template of a PPM to be used by Category III AIFs. Table 5.1 below outlines the important points which are covered under the PPM.

Table 5.1: Summary of PPM Disclosures by Category III AIF

Section	**Important Points covered in the PPM Section**
Executive Summary	The principle terms of the offering are summarized in this section, providing detailed information on: o Name of the Category III AIF and the Registration No. o Details of the Sponsor and the Manager, along-with affiliate entities, if any o Investment Objective, Investment Strategy, Leverage Strategy and Allocation process o Target Corpus of the Fund and Classes of Units to be issued to unit-holders o Terms of the Fund/Scheme, Offering Price per unit and Initial Offer Period o Minimum Capital Commitment from investors, Minimum Sponsor Commitment and Commitment Period, if applicable o Fee Structure of the fund, Hurdle rate of return for each class of units, calculation of high-water mark, rate and basis for the management fee and performance fee and other expenses of the fund o Redemption of units, including details on the lock-in period, redemption period and exit load

[58]SEBI Circular No.: SEBI/HO/IMD/DF6/CIR/P/2020/24 dated Feb 05, 2020 on Disclosure Standards for Alternative Investment Funds (AIFs) (issued on SEBI website on Feb 6, 2020)

Section	Important Points covered in the PPM Section
Market Opportunity/ Indian Economy/ Industry Outlook	Macro-economic background and data, showing investment outlook of the manager and industry outlook that may be relevant to the investment strategy of the fund, is provided in this section
Investment Objective, Strategy and Process	The investment objective of the Fund is detailed in this section, with the following information: o Fund Structure o Investment Objective o Target Securities and Sectors o Exposure Limits and Investment Limits for various investment positions o Leverage Strategy o Allocation to Overseas Investments or Securities, if any o Industry Allocation and Sector Allocation of Target Securities o Investment Process to be followed by the Fund
Fund/Scheme Structure	This section of the PPM provides a brief description of the activities of the Fund/Scheme and its constituents, including: o Sponsor o Trustee o Manager o Custodian o Investment Advisor, if any Brief profiles of key team members, of every fund constituent, are also provided in the PPM, along with other 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
Governance Structure	This section provides supplementary information on the fund constituents and details the constitution, manner of appointment, fees, roles and responsibilities of the following committees: o Valuation committee o Investment committee o Advisory board (if any) o Limited partner/investor advisory committee o Operating partners, advisor or portfolio company advisor (if any)

Section	Important Points covered in the PPM Section
	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 Fund[59]
Track Record of Manager	The following points are covered in this section in detail: o Historical Track Record of the Fund, which includes details of previous investments and exits o Track Record of Manager, as a "First-time Manager" or an "Experienced Manager" o Related Disclaimers and Risk Factors
Principal Terms of the Fund/Scheme	The following points are covered in this section in detail: o Total Target corpus, with targeted collection amounts at first close and final close. o Target Investors, considering the risk-return profile of the Fund o Minimum Capital Amount to be invested by investors and Sponsor/Manager o Redemption Terms, with details on redemption limits, applicable lock-in periods, exit load and notice period o Fee Structure, detailing Management Fee and Performance Fee calculation o Fund Expenses to be borne by Fund, such as operating expenses, set-up costs, distribution costs and other expenses o Target minimum return, known as Hurdle Return o Target Leverage o Identification of an Appropriate Benchmark for calculation of Additional Return earned by the Fund/Scheme, as compared to the Benchmark o Distribution Waterfall, to determine the methodology of distributing cash flows from the Fund to its stakeholders o Identification of Key Persons in the Fund, without whom the Fund may be meaningless to operate o Potential Conflict of Interest of the Investment Manager with Investors
Determination of the Net Asset Value of the Units	This section details the valuation principles used by the Manager for the determination of the net asset value of units of the Fund/Scheme, including: o Details of the entity to be appointed as the Valuer

[59] Inserted by the SEBI (Alternative Investment Funds) (Second Amendment) Regulations, 2021

Section	Important Points covered in the PPM Section
	○ Valuation Policy of the Fund/Scheme ○ Role and Constitution of the Valuation Committee
Conflict of Interest	This section provides information on potential conflict of interest between fund constituents and its stakeholders and steps taken by the Fund for effective resolution of such conflicts. Details on conflict of interest on account of ware-housing of investments or making co-investments are also disclosed.
Risk Factors	This section provides information on potential risk factors for a Category III AIF in the following areas: ○ Risk Factors related to Portfolio Investments ○ Risk Factors related to Fund Structure ○ Regulatory Risk Factors ○ General Risk Factors ○ Tax-related Risk Factors ○ Sector-specific Risk Factors ○ Currency related Risk Factors
Legal, Regulatory and Tax Considerations	This section provides standard language for legal, regulatory and tax considerations as applicable to the Fund/Scheme, covering the following laws: ○ Indian Trust Act, 1882 / Limited Liability Partnership Act, 2008 / Companies Act, 2013 - as may be applicable regarding the constitution of the Fund/Scheme. ○ Indian Securities Laws, covering provisions of the following acts: ▪ SEBI (Alternative Investment Funds) Regulations, 2012 ▪ SEBI Regulations on Initial Public Offerings, as per SEBI (Issue of Capital and Disclosure Requirements) Regulations, 2018 ▪ Takeover Regulations, as per the SEBI (Substantial Acquisition of Shares and Takeovers) 46 Regulations, 2011 ▪ Insider Trading Regulations, as per the SEBI (Prohibition of Insider Trading) Regulations, 2015 ▪ Anti-money Laundering provisions of the Prevention of Money Laundering Act, 2002 ○ Relevant provisions of the Companies Act, 2013 depending on investment strategy/ type of instrument that the Fund seeks to invest in. ○ Relevant provisions of the Competition Act, 2002 depending on investment strategy/ type of instrument that the Fund seeks to invest in.

Section	Important Points covered in the PPM Section
	○ Foreign Investment Laws: ▪ Relevant provisions of Foreign Exchange Management Act (FEMA) ▪ Relevant provisions of SEBI (Foreign Portfolio Investors) Regulations ○ Taxation Regime for the Fund/Scheme, covering: ▪ Characterization of income and applicable tax rates on various sources of income ▪ Securities Transaction Tax (STT) ▪ General Anti-Avoidance Rules (GAAR) ▪ Goods and Service Tax (GST) ○ Other regulatory considerations, based on the sector focus of the AIF
Illustrations of Fees, Expenses and Other Charges	This section provides a year-wise illustration of the fees and expenses charged by the fund/scheme, to indicate the net amount invested in the fund/scheme every year after accounting for the capital contributions received from all class of investors and allocation of fees and expenses made to such class of investors.
Distribution Waterfall	This section provides a standard template and assumption, if any, for computing the following: ○ Capital commitment received and drawn down by every class of investors ○ Computation of Net Asset Value and allocation of Performance Fees by every class of investors. Every fund can make additional disclosures and insert appropriate assumptions, as may be relevant for this section.
Disciplinary History	This section provides information on all disciplinary actions and investigations, including current status of pending enforcement actions, against the entities of the Fund. Entities against which disciplinary action would be taken include the Sponsor, Manager, Trustee, Associates of Sponsor, Associates of Manager, Directors/ Partners of Sponsor, Directors/ Partners of Manager and Directors/ Partners of Trustee. Disciplinary History is provided in a tabular format, based on the regulator initiating the action, i.e. domestic or foreign regulator, and based on the nature of disciplinary action, i.e. civil or criminal cases.
Glossary	Definitions in relation to all the terms and abbreviations used in the PPM are presented in this section.

Section	Important Points covered in the PPM Section
Supplementary Information	Any additional information in relation to the Fund/Scheme, Investment Manager or investment team which does not form part of the standard disclosures is presented in this section.

AIFs need to mandatorily carry out a yearly audit of the Private Placement Memorandum, at the end of each financial year, to ensure compliance with the terms of the PPM. The audit findings along with the proposed corrective measures are to be communicated to the stakeholders within 6 months from the end of the financial year. Please refer to the detailed discussion on audit of PPM in section 4.2.8 of Unit 4.

A Category III AIF shall share losses in the fund with all investors based on their pro-rata holding in the fund. No scheme of a Category III 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 Category III 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.[60]

5.6 Guidelines on Operational, Prudential and Reporting Norms

It is mandatory for all registered Category III AIFs to comply with the directions issued by SEBI from time to time, with respect to operational standards, conduct of business rules, prudential requirements, restrictions on redemptions and conflict of interest. Such disclosures and compliance ensure that Investment Managers are not taking excess leverage in the Fund, managing risk effectively and conducting the business of the Fund for the benefit of the investors.

SEBI, in this regard, has issued a couple of circulars which provide detailed guidelines for all registered Category III AIFs, with respect to the Operational, Prudential and Reporting Norms.[61] The guidelines are discussed below:

5.6.1 Risk Management and Compliance

If a Category III AIF deploys leverage, the Fund must ensure that it:

- implements a comprehensive risk management framework, with independent risk management function commensurate with the size, complexity and risk profile of the fund.

[60] SEBI Circular No.: SEBI/HO/AFD-1/PoD/P/CIR/2022/157 dated November 23, 2022 on Schemes of AIFs which have adopted priority in distribution among investors

[61] SEBI Circular Nos.: CIR/IMD/DF/10/2013 dated July 29, 2013 on Operational, Prudential and Reporting Norms for Alternative Investment Funds and CIR/IMD/DF/14/2014 dated June 19, 2014 on Guidelines on disclosures, reporting and clarifications under AIF Regulations.

- maintains independent compliance function with suitable operational resources, infrastructure, checks and controls.

- maintains records of all trades and transactions performed in the Fund and makes it available to SEBI, when required.

- provides full disclosures of present and potential conflict of interests along with its resolution mechanisms to the investors and SEBI.

5.6.2 Redemption Norms

The following redemption norms, as specified by SEBI, are applicable to all open-ended Category III AIFs: These norms do not apply to closed-ended funds due to their unique fund structure.

- Investment Managers must ensure sufficient liquidity in the Fund/Scheme in order to meet redemption obligations. The Investment Manager should establish and maintain efficient liquidity management policy and process to ensure that liquidity of the fund assets is consistent with overall liquidity requirements of the Fund, when making investments.

- Investment Managers must disclose the possibility of suspension of redemptions in exceptional circumstances. Such suspension shall be justified, only if it deemed to be in best interest of the investors or as required by SEBI.

- Investment Managers shall build required operational efficiency and capability to suspend the redemptions, and shall not accept any new subscriptions or commitments from investors, during the period of such suspension.

- Follow-on action after suspension of redemptions:
  - The decision of suspension, with sufficient reasons and future actions, must be documented by the Investment Managers and communicated to SEBI and investors. The Investment Managers must also regularly review the suspension.
  - The Investment Manager must take all necessary steps to resume normal operations as soon as possible, in the best interest of investors. Such decision to resume normal operations shall also be communicated to SEBI and the investors.

5.6.3 Prudential Norms

A Category III AIF may take leverage, whether through investments in derivative contracts or by borrowed money, for the purpose of investing in securities market. However, SEBI has prescribed that the leverage of a Category III AIF shall not exceed 2 times of the net asset value (NAV) of the fund. For the purpose of limiting leverage taken by the Fund, SEBI has prescribed the ratio to compute the maximum permissible leverage by the Fund, as under:

$$\text{Leverage} = \frac{\text{Total exposure \{Long positions + Short positions (after offsetting as permitted)\}}}{\text{Net Asset Value (NAV)}}$$

i.e. the leverage of a Category III AIF shall not exceed 2 times of the net asset value (NAV) of the fund.

Net Asset Value (NAV) of the AIF shall be the sum of value of all securities adjusted for Mark-to-market gains/losses (including cash and cash equivalents). The NAV shall exclude any funds borrowed by the AIF.

For instance, if the current Assets under Management of Fund ABC as on March 31, 2020 is Rs. 50 crore, then the total exposure taken in the fund, after offsetting long positions and short positions shall not exceed Rs. 100 crore. It may be noted that the leverage ratio shall be calculated at the scheme level.

Category III AIFs investing in units of other AIFs may undertake leverage not exceeding 2 times the NAV, which excludes the value of investment in units of other AIFs.[62]

Breach of Leverage Limits:

All registered Category III AIFs shall monitor leverage limits, as prescribed by SEBI, on a continuous basis and have adequate infrastructure for the purpose. The Category III AIFs must report the amount of leverage at the end of the day, based on closing prices, to the custodian by the end of next working day. The Category III AIFs must also report any breach of leverage limit during the day.

In case a breach of limit is reported by the Category III AIF, the Category III AIF and the custodian have their respective duties to inform the investors and SEBI about such breach, in the following manner:

- Reporting Obligation of Category III AIF:
    - The Category III AIF must report the breach of the leverage limit to the Custodian.
    - The Category III AIF must send a report to all the investors before 10:00 AM on the next working day, informing them about the breach and reasons for such breach.

[62] As per SEBI Circular No. SEBI/HO/IMD-I/DF6/P/CIR/2021/584 dated June 25, 2021

- The Category III AIF must square-off (sell/buy) the excess exposure taken in any security or derivate contract by end of the next working day, in order to be within the leverage limit. A confirmation of such square-off must be sent to all investors by end of the same day.

- Reporting Obligation of Custodian:

    - The Custodian shall send a report to SEBI, mentioning the name of the Category III AIF, extent of breach of leverage limit and reasons for such breach, before 10:00 AM on the next working day.

    - A confirmation of square-off of excess exposure must be sent to SEBI by end of the same day on which the exposure is squared-off.

5.6.4 Submission of Reports to SEBI:

All Category III AIFs shall submit periodical reports to SEBI relating to their activities as an AIF in a prescribed format. Category III AIFs which do not undertake leverage shall submit this report on a quarterly basis, within 10 calendar days from the end of each quarter in the revised format as specified by SEBI.[63] [64] Category III AIFs which undertake leverage are required to submit reports on a monthly basis to SEBI. The reports should be submitted online through the SEBI Intermediary Portal.

5.7 Conditions for investments by a Category III AIF

Category III AIFs are allowed to invest in securities of listed and unlisted investee companies, derivatives, units of other AIFs and complex or structured products. Category III AIFs can also invest in an Investee Company up to the specified concentration limit, directly or through, units of other AIFs.[65] Category III AIFs may deal in goods received in delivery against physical settlement of commodity derivatives.[66] Such derivative contracts may involve physical settlement of commodities such as precious metals, base metals, agricultural products and energy products.

Category III AIFs can also transact in Corporate Bonds through the Request for Quote (RFQ) platform of stock exchanges.[67] To enhance transparency and disclosure of trades in the secondary market for Corporate Bonds, Category III AIFs shall undertake at least 10 percent

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[63] As per the SEBI Circular No. SEBI/HO/IMD/IMD-I/DOF6/CIR/2021/549 dated April 07, 2021

[64] The report format can be accessed at: https://www.sebi.gov.in/sebi_data/commondocs/apr-2021/GENERAL%20INFORMATION%20ABOUT%20THE%20AIF%20Annexure%201_p.pdf

[65] Vide SEBI (Alternative Investment Funds) (Second Amendment) Regulations, 2021 w.e.f. May 5, 2021.

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

[67] As per 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.

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). If a Category III 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 a Category III 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.[68]

Category III AIFs may invest in units of other AIFs without labelling themselves as a Fund of Category III AIF.[69] A Fund of Category III AIF is a kind of a diversified fund structure, which may invest in units of other AIFs having different investment strategies, instead of investing in listed or unlisted securities or derivative contracts. A Category III AIF which is authorised under the fund documents to invest in units of AIFs shall not offer its units for subscription to other AIFs. [70] Existing Category III 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 consent of at least two-thirds of unit holders by value of their investment in the AIF.[71]

A Category III AIF which proposes to invest in units of other AIFs shall, inter-alia, provide the following information in their PPM:[72]

- Proposed allocation of investment in units of other AIFs.
- The portion of fees and expenses which may be attributed to investment in units of other AIFs, out of the total fees and expenses charged to the investors by the Category III AIF.
- Process to be followed by the Investment Manager of the Category III AIF to ensure compliance with the Investment Restrictions and Concentration Limits applicable to Category III AIFs, as per the SEBI (Alternative Investment Funds) Regulations.
- Disclosure with respect of any investments proposed to be made in units of other AIFs managed/sponsored by the same Investment Manager/Sponsor or associates of the Investment Manager/Sponsor. Details of such investment and the allocation of fees and expenses, relating to such investment, should also be provided.

As per SEBI (Alternative Investment Funds) Regulations, investments made by any Category III AIF are subject to the following investment conditions:

[68] SEBI Circular No.: SEBI/HO/DDHS/DDHS_Div1/P/CIR/2022/142 dated October 19, 2022
[69] As per SEBI Circular No. SEBI/HO/IMD-I/DF6/P/CIR/2021/584 dated June 25, 2021
[70] Vide SEBI (Alternative Investment Funds) (Second Amendment) Regulations, 2021 w.e.f. May 5, 2021.
[71] As per SEBI Circular No. SEBI/HO/IMD-I/DF6/P/CIR/2021/584 dated June 25, 2021
[72] As per SEBI Circular No. SEBI/HO/IMD-I/DF6/P/CIR/2021/584 dated June 25, 2021

- Co-Investments are very common wherein the Investment Manager may invest in the same securities, when investing on behalf of the Category III AIF, for other clients or for the manager's proprietary account. In order to treat such potential conflicts, the Investment Manager is prohibited from dealing in the same security for other clients at more favourable terms which are offered to the Category III AIF. Further, terms of exit including the exit timing need to be identical for both Investment manager and AIF.

  For example**,** Fund ABC has appointed an Investment Manager PQ to manage the Fund Portfolio. Manager PQ has decided to buy 50 lakh shares of a small-cap company, MNC Ltd. at Rs. 8.00/share. With this trade, the investment manager also wants to purchase 10 lakh shares of MNC Ltd. for three other discretionary clients, individually.

  In such a scenario, Investment Manager PQ shall ensure that Fund ABC is not paying more than Rs. 8.00/share when purchasing the shares. Therefore, the manager is required to purchase 50 lakh shares of MNC Ltd., if available, at Rs. 8.00/share in the Fund's Account first. If there are any more outstanding shares of MNC Ltd. in the market, the manager can then purchase 30 lakh shares for other three clients.

- A Category III AIF can invest in foreign entities or investee companies, incorporated outside India, provided they are in compliance with regulatory guidelines issued by RBI and SEBI.

- A Category III AIF may take leverage or borrow money for the purpose of investing in securities market, provided:

  - Prior consent of investors is taken by the investment manager.
  - Maximum leverage taken shall not breach the limits specified by SEBI from time to time. Currently the maximum leverage limit is set at 2 times of the Net Asset Value (NAV) of the Fund. Category III AIFs investing in units of other AIFs may undertake leverage not exceeding two times the NAV, which excludes the value of investment in units of other AIFs.[73]
  - Disclosures are made to investors and SEBI periodically, regarding the leverage levels. Such disclosures shall provide information on:
    - overall level of leverage employed
    - the level of leverage arising from borrowing of cash
    - the level of leverage arising from position held in derivative contracts
    - main source of leverage in the Fund

Un-invested portion of the investable funds and divestment proceeds pending distribution to investors, of a Category III AIF, 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

[73] As per SEBI Circular No. SEBI/HO/IMD-I/DF6/P/CIR/2021/584 dated June 25, 2021

Settlement, Commercial Papers, Certificates of Deposits, etc. till the deployment of funds as per the investment objective or the distribution of the funds to investors as per the terms of the fund documents, as applicable.[74] If a Category III AIF has Non-Resident Indian (NRI) investors contributing to the fund, temporary investments made by such funds would be subject to additional restrictions as per the prevailing RBI guidelines.

Category III AIF requires approval from 75 percent of investors, by value of their investment in AIF to investment in associates or units of AIFs managed or sponsored by its Manager, Sponsor or associates of its Managers or Sponsors.[75] Further, Category III AIFs require approval from 75 percent of investors by value of their investment in the AIF and such conditions specified by SEBI, in order to buy or sell securities from or to:[76]

- Associates or
- Schemes of AIFs managed or sponsored by its Manager, Sponsor or associates of its Manager or Sponsor or
- An investor who has committed to invest at least 50 percent of the corpus of such Category III AIF scheme. Such investor shall be excluded from the voting process in order to obtain required approval of 75 percent of investors, by their value of investment in the fund.

An associate entity means a Company, or a limited liability partnership (LLP), or a body corporate in which a director or trustee or partner or Sponsor or Manager of the Fund, or director or partner of the Investment Manager/ Sponsor, holds either individually or collectively, more than 15 percent of its paid-up equity share capital or partnership interest.

5.8 Concentration Limits

A Category III AIF can invest up to 10 percent of the investible funds in one Investee Company directly or through investment in units of other AIFs. However, large value funds for accredited investors of Category III AIFs may invest up to 20 percent of the investable funds in an investee company directly or through investment in units of other AIFs.[77].

"Investable Funds" has a different meaning than "Fund Corpus" of the Fund or Scheme. Investable Funds means the fund corpus, net of expenditure for administration and management of the fund estimated for the tenure of the fund.[78].Fund Corpus is defined as

[74] Vide SEBI (Alternative Investment Funds) (Fourth Amendment) Regulations, 2018 w.e.f. August 13, 2021.
[75] Vide SEBI (Alternative Investment Funds) (Second Amendment) Regulations, 2021 w.e.f May 5, 2021.
[76] Vide SEBI (Alternative Investment Funds) (Second Amendment) Regulations, 2023 w.e.f. June 15, 2023.
[77] Inserted via SEBI (Alternative Investment Funds) (Second Amendment) Regulations, 2022 w.e.f. March 16, 2022.
[78] Inserted via SEBI (Alternative Investment Funds) (Fourth Amendment) Regulations, 2018 w.e.f. August 13, 2021

the total amount committed by all investors, by way of a written contract or any such document as on a particular date, for the said scheme of the Category III AIF. Tenure is the duration of scheme from the date of first close till last day of the term as specified in the fund documents.[79]
It is important to note that the 10 percent concentration limit is applicable as per the cost of the investments made by the Category III AIF, and not as per the market value of such investment. The importance of this concentration limit is to avoid the risk of concentration of investments in only one or few companies, while looking for short-term gains and returns.

SEBI further notified that a Category III AIF can calculate its investment concentration based on either 'Investable Funds' or the 'Net Asset Value' (NAV) of the scheme, while investing in listed equity of an investee company. All Category III AIFs shall disclose the basis for calculation of investment concentration norm in the PPM document and shall not be changed during the tenure of the scheme.[80]

For Category III AIFs calculating the investment concentration based on the Net Asset Value (NAV) of the scheme, the following is specified:[81]

- The limit for investment in listed equity shall be calculated based on the NAV of the fund on the business day immediately preceding the date on which the Category III AIF makes such investment.
- NAV of the AIF shall be the sum of value of all securities adjusted for mark to market gains/losses, including cash and cash equivalents. The NAV shall exclude any funds borrowed by Category III AIFs.
- Passive breach of concentration norms shall be rectified within 30 days from the date of the breach.

The Investment Manager must ensure that appropriate risk management measures are implemented to avoid any breach of concentration limit. The concentration limit of 10 percent is on the investable funds and not on total contributions from one investor. Hence, if the commitments of a Category III AIF are Rs. 100 crore and the first investment contribution made by an institutional investor is Rs. 10 crore, such contribution received could entirely be invested in one security, making it 10 percent of the fund corpus. However, such investment made by the Investment Manager would be highly risky from the point of view of the institutional investor, and hence should be avoided as further capital contribution may or may not be made by the institutional investor in subsequent drawdowns.

5.9 Category III AIFs: Open-ended v/s Close-ended

All Category III AIFs are either open-ended or close-ended, as structured by the Sponsor or Investment Manager, at the time of registration. In contrast to this, all Category I AIFs and Category II AIFs are compulsorily close-ended and the tenure of such funds is determined at the time of registration.

[79] Vide SEBI (Alternative Investment Funds) (Fourth Amendment) Regulations, 2022 w.e.f. November 15, 2022.
[80] SEBI Circular No.: SEBI/HO/IMD/IMD-I/DOF6/P/CIR/2022/0000000037 dated March 28, 2022 on Calculation of investment concentration norm for Category III AIFs.
[81] SEBI Circular No.: SEBI/HO/IMD/IMD-I/DOF6/P/CIR/2021/663 dated November 22, 2021 on Clarification regarding amendment to SEBI (AIF) Regulations, 2012.

In an open-ended fund structure:

- Investors contribute their capital upon admission or subscription to the Fund, through the Initial Offer Period.
- 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 case of an open-ended Category III AIF, the first single lump-sum investment amount received from the investor should not be less than Rs. 1 crore. Additional contribution made by such investor, after the first investment in the Category III AIF, has no such limit. In case of partial redemption of units by an investor, the open-ended Category III AIF shall ensure that after such redemption, the amount of investment retained by the investor in the fund does not fall below the minimum investment limit i.e. Rs. 1crore.[82]

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.

5.10 Category III AIFs: Direct Plan Vs. Plans through Distributors[83]

Schemes of Category III AIFs shall have an option of “Direct Plan” for investors. Similar to Mutual Funds, such direct plan should not entail any distribution fee or placement fee. Category III AIFs shall ensure that investors who approach the fund 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.

Category III AIFs shall disclose the distribution fee or placement fee, if any, to the investors of the Category III AIF at the time of on-boarding. Such funds shall charge distribution fee or placement fee, if any, to investors only on equal trail basis i.e. no upfront distribution fee or placement fee shall be charged by Category III AIFs directly or indirectly to their investors.

[82] SEBI Circular No.: CIR/IMD/GF/14/2014 dated June 19, 2014 on Guidelines on disclosures, reporting and clarifications under AIF Regulations.
[83] SEBI Circular No.: SEBI/HO/AFD/PoD/CIR/2023/054 dated April 10, 2023 on Direct plan for schemes of AIFs and trail model for distribution commission in AIFs.

Further, any distribution fee or placement fee paid shall be only from the management fee received by the managers of such Category III AIFs.

5.11 Dematerialisation of AIF units[84]

All Category III AIFs shall dematerialize their units in the following time frame:

Particulars	Category III AIF Schemes, with Corpus of Rs. 500 crore and above	Category III AIF Schemes, with Corpus of less than Rs. 500 crore
Dematerialization of all units issued	Latest by October 31, 2023	Latest by April 30, 2024
Issuance of units only in Dematerialized Form	November 01, 2023 onwards	May 01, 2024 onwards

Dematerialisation of units is not applicable for Category III AIF schemes whose tenure is ending on or before April 30, 2024. In case of transfer of units of a Category III AIF by its investors in dematerialised form, the terms of such transfer shall be governed by the PPM, Contribution Agreement signed by investors and any other documents.
In addition to above, Depositories shall put in place a system to facilitate any transfer of units of AIFs, held in dematerialised form, only after approval of AIF/manager of the AIF, wherever applicable.

5.12 First Close, Final Close and Fund Tenure[85]

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 a Category III 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.

In case of open-ended schemes of Category III AIFs, the First Close shall refer to the close of their Initial Offer Period.

At the date of declaration of First Close, the corpus of any Category III AIF shall not be less than the minimum corpus of twenty crore rupees, as prescribed by SEBI (Alternative Investment Funds) Regulations. Sponsor commitment in the Category III AIF, at the date of

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[84] SEBI Circular No.: SEBI/HO/AFD/PoD1/CIR/2023/96 dated June 21, 2023 on Issuance of units of AIFs in dematerialized form.
[85] SEBI Circular No.: SEBI/HO/AFD-1/PoD/P/CIR/2022/155 dated November 17, 2022 on Guidelines for AIFs for declaration of first close, calculation of tenure and change of sponsor/manager or change in control of sponsor/manager.

declaration of First Close shall not be reduced, withdrawn or transferred, after declaration of First Close.

Existing Category III AIFs who have not declared their First Close, shall declare their First Close within 12 months from November 17, 2022 (i.e., the date of relevant SEBI Circular). However, existing Category III 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.

For Large Value Funds (LVFs), the First Close must be declared within 12 months from the date of grant of registration of the Category III AIF or date of filing of PPM of scheme with SEBI, whichever is later. Existing LVFs shall declare their First Close within 12 months from November 17, 2022.

It is further clarified that if the First Close of a Category III AIF scheme is not declared within the timeline prescribed above, the Category III 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.

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 a specific Category III 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 Category III AIF cannot accept more investors after the final close of the fund. However, an open ended Category III AIF can accept money from the investors, at any time after the final close of the fund.

Unlike Category I and II AIFs, all Category III AIFs do not have a minimum tenure of 3 years. The tenure for a close-ended Category III AIF is determined at the time of Registration with SEBI and is computed from the date of declaration of the First Close. The Category III 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 Category III AIF scheme.

Existing Category III 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 of Category III AIFs, 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.

In case of close-ended Category III AIFs, the tenure of the Fund can be extended up to an additional period of 2 years, with two individual extensions of 1-year each. Such extension of fund tenure is subject to approval of two-thirds of the investors by value of their investment in the Category III AIF. In absence of such consent from investors or upon expiry of the extended tenure, the fund shall be wound up.[86]

For example, Fund LMN is a close-ended Category III AIF with tenure of 5 years. It has filed the PPM document with SEBI on 1st June, 2023 and has received SEBI approval on September 15, 2023, for launching a close-ended scheme "LMN Growth Fund I" with Total Capital Commitments of Rs. 300 crore. Fund LMN will need to declare first close on or before 31st May 2024, and tenure of 5 years would start from the day the First Close is declared.
If Fund LMN has declared its First Close on November 15, 2023, then 5 years will commence from November 15, 2023 and the tenure will end on November 14, 2028.

Let us assume that the Total Net Asset of the fund as on November 14, 2028, is Rs. 600 crore. The scheme is eligible for extension for two more years till November 14, 2030. For the extension:

- Investment Manager shall seek approval, before November 14, 2028, from the investors. The approval can be sought for one year at a time and maximum of two such extensions are allowed. First extension would be till November 14, 2029 and if required, one more extension can be sought for another year ending November 14, 2030.

  Approval must be sought from investors having units worth at least Rs. 400 crore in the Fund. (i.e. two-thirds of the investors by value of their investment on November 14, 2028)

- Large value fund for accredited investors (LVF) may be permitted to extend its tenure beyond 2 years, subject to terms of the contribution agreement, other fund documents and such conditions as may be specified by SEBI:[87] The PPM, contribution agreement or other fund documents of LVF shall lay down terms and conditions for extension of the tenure beyond 2 years.
- The Trustee/Board of Director/Designated Partners of the LVF shall give their approval at least one month before expiration of the fund tenure or extended tenure.
- The LVF shall liquidate and wind up in accordance with SEBI (Alternative Investment Funds) Regulations in case of non-adherence to the PPM, contribution agreement or other fund documents of LVF for the said extension.

5.13 Fund raising process – Regulatory requirements

The following table (Table 5.2) provides an indicative process of the Fund-raising activity, for a Category III AIF.

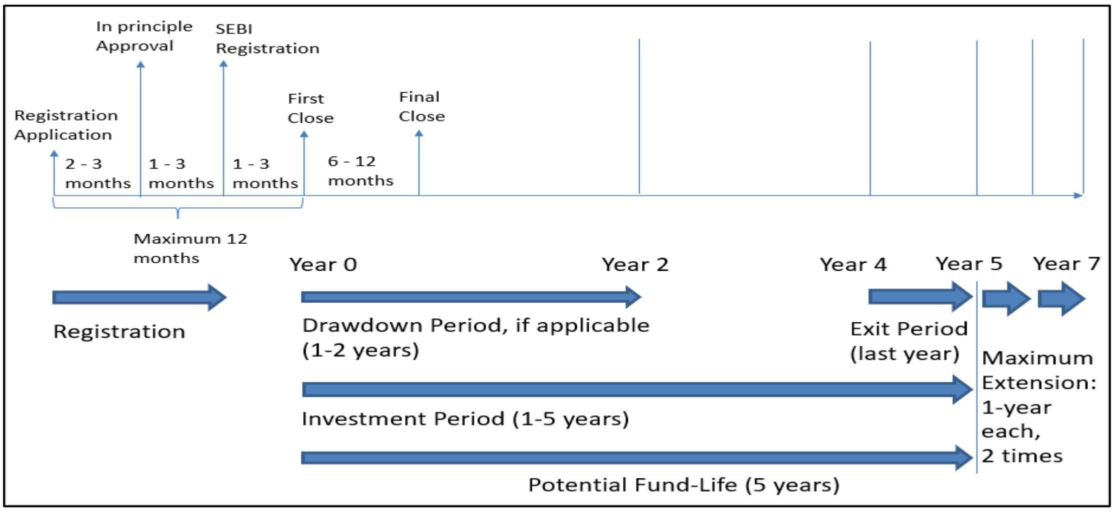
[86] Vide SEBI (AIF) (Second Amendment) Regulations, 2023 w.e.f. June 15, 2023.
[87] SEBI Circular No.: SEBI/HO/AFD/RAC/CIR/2022/088 dated June 24, 2022 on Guidelines for Large Value Funds for Accredited Investors under SEBI (AIF) Regulations, 2012 and Requirement of Compliance Officer for Managers of all AIFs.

Table 5.2: Fund-raising Process – Category III AIF

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.
Step 2	Apply for SEBI Registration	File PPM and make application in specified format (Form A) through a Merchant Banker.
Step 3	Receive SEBI In-principle Approval	Based on initial application filed, SEBI grants in-principal approval. This is followed by opening of bank accounts, custody accounts, demat accounts, registration at SCORES platform etc. 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 Category III 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.

Figure 5.1 graphically represents the different phases in a close-ended Category III AIF, with tenure of five years.

Figure 5.1: Fund Life-cycle of a close-ended Category III AIF, with 5-year tenure



5.14 Listing of Close-ended Funds/ Schemes

Units of a scheme launched by a close-ended Category III AIF are eligible for listing on a recognized stock exchange. The scheme should have a minimum tradable lot of Rs. 1 crore and listing shall be permitted only after final close of the fund or scheme. Listing of close-ended funds/schemes on a recognized stock exchange is voluntary.

In order to get listed on a recognized stock exchange:

I. A Category III 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 Category III 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.

5.15 Category III AIFs: Participation in Credit Default Swaps[88]

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.[89]

Category III AIFs may buy credit default swaps for the purpose of hedging or taking additional exposure, subject to permissible leverage limits as discussed earlier. Similarly, Category III AIFs may sell CDS subject to the condition that effective leverage undertaken at the scheme level is within permissible leverage limits. Further, the total exposure to one investee company, including the exposure through CDS, shall be within the concentration limits applicable to Category III AIFs, as mentioned in the SEBI (Alternative Investment Funds) Regulations.

Category III 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.

CDS exposures taken by a Category III AIF shall be reported to the custodian by the next working day. The Custodian shall put in place a mechanism to collect necessary details from Category III 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 Category III AIFs, the reporting obligation and necessary actions vest on the manager/AIF and the Custodian.[90]

If a Category III AIF sells CDS by earmarking securities and in case the amount of earmarked securities falls below the CDS exposure, then:

- The Category III AIF shall send a report to the custodian on the same day of the breach.
- The Category III 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 Category III 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 a Category III AIF takes an unhedged position in a CDS, then the Category III AIF should ensure that the gross unhedged positions are up to 25 percent of investable funds of the

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[88] SEBI Circular No.: SEBI/HO/AFD/PoD/CIR/2023/15 dated January 12, 2023 on Participation of AIFs in Credit Default Swaps.

[89] Master Direction – Reserve Bank of India (Credit Derivatives) Directions, 2022 w.e.f. May 9, 2022.

[90] 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 1of SEBI Circular No. CIR/IMD/DF/14/2014 dated June 19, 2014.

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.

All CDS transactions shall be done on a platform regulated by SEBI or Reserve Bank of India (RBI), to enhance transparency and disclosure. Category III 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.

5.16 General obligations and responsibilities of a Category III AIF

5.16.1 General Obligations:[91]

As per SEBI (Alternative Investment Fund) Regulations, all AIFs including Category III AIFs shall have the following general obligations:

- All Category III AIFs shall have detailed policies and procedures, as approved jointly by the Manager and the trustee or trustee company or designated partners or directors of the Fund, so as to ensure that all the decisions of the Fund are in compliance with the SEBI (Alternative Investment Funds) Regulations, terms of the PPM, agreements made with investors, other fund documents and applicable laws. Such policies and procedures should be reviewed, as per internal policies of the fund and SEBI Regulations, on a regular basis. The Manager shall be responsible for every decision of the Category III AIF.

- The Manager shall be responsible for every decision of AIF, including ensuring that decisions are in compliance with SEBI (AIF) Regulations, terms of the placement memorandum, agreements made with investors, other fund documents, applicable laws and other internal policies.
- The Investment Manager may constitute an Investment Committee (called by any name) to approve all the investment decisions of the fund.

- The Manager and the members of the Investment Committee shall jointly ensure that all the investments of the fund are in compliance with the SEBI (Alternative Investment Funds) Regulations, terms of the PPM, agreement with the investors and any other fund documents or applicable laws. However, this shall not apply to funds in which each investor, other than the Sponsor, Manager, or employees and directors of the fund or manager has:
    - committed to invest minimum Rs. 70 crore (or equivalent amount in other currency), and

[91] Vide SEBI (Alternative Investment Funds) (Second Amendment) Regulations, 2021 w.e.f. May 5, 2021.

- furnished a waiver, in the SEBI prescribed format, to the fund in respect of compliance with the said condition.[92]

- External members of the Investment Committee, whose names are not disclosed in the PPM, at the time of on-boarding investors, shall be appointed only with the consent of at least seventy five percent of the investors by their value of investment in the Category III AIF. Such 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.[93]

- All Category III AIFs shall inform SEBI about any material change from the information provided by the Fund in the Private Placement Memorandum (PPM), at the time of application for registration.

- In case of change of Sponsor or Manager, or change in control of the Category III AIF, Sponsor or Investment Manager of the fund, prior approval from SEBI must be taken by the AIF to carry on investment activities. Such approval is subject to a fee equivalent to the Registration Fee for Category III AIFs, i.e., Rs. 15 lakh. The cost incurred towards such fee by the sponsor or manager cannot be passed on to the investors of a Category III AIF. The fees should be paid within 15 days of effecting the change of Sponsor or Manager, or change in control of the Sponsor or Manager of the Category III AIF.[94]

- In case of simultaneous change of Sponsor or Manager, or change in control of the Category III AIF, Sponsor or Investment Manager of the Category III AIF, a single fee of Rs. 15 lakh shall be levied, as mentioned above.

- No fees shall be levied if there is a change in the Sponsor, or change in Control of the Sponsor due to:
    - Replacement of Sponsor by the Manager, or the manager acquiring control in the Category III AIF.
    - Exit of one sponsor, in case a Category III AIF has multiple sponsors.

- If there is a proposed change in the control of the Sponsor and/or Manager of a Category III AIF as per a scheme of arrangement awaiting the sanction of National Company Law Tribunal (NCLT) under Companies Act, then such Category III AIF shall file an application with SEBI seeking approval for the proposed change in control of the Sponsor and/or Manager of the fund, before filing the application with the NCLT.[95]

[92] Vide SEBI (Alternative Investment Fund) (Amendment) Regulations, 2021 w.e.f. January 8, 2021 and SEBI Circular No.: SEBI/HO/IMD/DF6/CIR/P/2021/004 dated January 8, 2021.
[93] As per SEBI Circular No. SEBI/HO/IMD-I/DF6/P/CIR/2021/584 dated June 25, 2021
[94] SEBI Circular No. SEBI/HO/AFD-1/PoD/P/CIR/2022/155 dated November 17, 2022 on Guidelines for AIFs for declaration of first close, calculation of tenure and change of sponsor/manager or change in control of sponsor/manager.
[95] SEBI Circular No.: SEBI/HO/IMD-1/DF9/CIR/2022/032 dated March 23, 2022 on Change in control of Sponsor and/or Manager of AIF involving scheme of arrangement under Companies Act, 2013.

- All changes in terms of the PPM and in the documents of the Category III AIF 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 documents of the Category III AIF, along-with the relevant pages of revised sections/clauses.[96]

- The books of accounts of the Category III AIF shall be audited annually by a qualified auditor.

- The 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 Alternative Investment Fund managed by it makes investment.

- The Manager and sponsor of a Category III AIF shall ensure that the assets and liabilities of each scheme of an Alternative Investment Fund are segregated and ringfenced from other schemes of the fund; and bank accounts and securities accounts of each scheme are segregated and ring-fenced.

- The Manager of a Category III AIF 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. Such Compliance Officer shall meet the eligibility criteria specified by SEBI and shall provide an Independent Report to SEBI with respect to any non-compliance by the AIF, immediately or within 7 working days from the date of observing such non-compliance.[97]

- All Category III AIFs shall ensure that the Investment Manager designates an employee or director as Compliance Officer who shall be a person other than CEO of the Investment Manager. The compliance officer shall be responsible for monitoring compliance with the provisions of the SEBI Act, SEBI (Alternative Investment Funds) Regulations and circulars issued thereunder.[98]

- Category III 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.[99] The Sponsor or Manager of such Category III AIF shall further submit an undertaking to SEBI in this regard.

- Category III 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

[96] SEBI Circular No. SEBI/HO/IMD/IMD-I/DOF6/CIR/2021/549 dated April 07, 2021

[97] Vide SEBI (Alternative Investment Funds) (Second Amendment) Regulations, 2023 w.e.f. June 15, 2023.

[98] 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 (Alternative Investment Funds) Regulations, 2012 and Requirement of Compliance Officer for Managers of all AIFs.

[99] SEBI Circular No.: SEBI/HO/AFD-1/PoD/CIR/P2022/108 dated August 17, 2022 on Guidelines for overseas investment by AIFs/VCFs.

Multilateral Memorandum of Understanding (Appendix A Signatories) or a signatory to the bilateral Memorandum of Understanding with SEBI.

- Category III 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 a Category III 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 Category III AIF. The Category III 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 Category III 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 Category III 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.

5.16.2 Code of Conduct

The Category III AIF, 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 etc. shall abide by the Code of Conduct specified in Fourth Schedule of the SEBI (Alternative Investment Funds) Regulations, as follows:[100]

I. Code of Conduct for AIFs:

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 (Alternative Investment Funds) 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.

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

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.

II. Code of Conduct for the Managers of AIFs 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 Category III AIFs 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 Category III AIF and ensure that decisions are taken in the interest of the investors;
e) Abide by the policies of the Category III 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;
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 Category III 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; and
n) Maintain confidentiality of information received from investee companies and companies seeking investments from the Category III AIF, unless explicit confirmation is received that such information is not subject to any non-disclosure agreement.

For this purpose, key management personnel of the Category III AIF shall include: [101]

a) Members of the key investment team of the Investment Manager, as disclosed in the PPM;
b) Employees involved in the decision-making process on behalf of the Category III AIF, including 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
c) Any other person whom the Category III AIF or the Investment Manager may declare as a key management personnel.

The Category III AIF shall disclose the names of all the key management personnel of the Category III AIF and the Investment Manager, as mentioned above, in the PPM. Any change in the key management personnel shall be intimated to the investors and SEBI.

III. Code of Conduct for the members of the Investment Committee, trustee, trustee company, directors of the trustee company, directors or designated partners of AIF:

Members of the Investment Committee, trustee, trustee company, directors of the trustee company, directors or designated partners of AIF shall:

a) Maintain integrity and the highest ethical and professional standards of conduct;
b) Ensure proper care and exercise due diligence and independent professional judgment in carrying out their roles;
c) Disclose details of any conflict of interest relating to any/all decisions in a timely manner to the Manager of the Category III AIF, adhere with the policies and procedures of the Fund with respect to any conflict of interest and wherever necessary, recuse themselves from the decision making process;
d) Maintain confidentiality of information received regarding the Category III AIF, its investors and investee companies; unless explicit confirmation is received that such information is not subject to any non-disclosure agreement.
e) Not indulge in any unethical practice or professional misconduct or any act, whether by omission or commission, which tantamount to gross negligence or fraud

5.16.3 Exemption from enforcement of the regulations in special cases:

A Category III AIF, a person or a class or 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 markets. 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.[102]

[101] 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.
[102] Inserted by SEBI (Regulatory Sandbox) (Amendment) Regulations, 2020 and amended by SEBI (Regulatory Sandbox) (Amendment) Regulations, 2021, w.e.f. 03.08.2021

5.16.4 Conflict of Interest:

The Sponsor and Investment Manager of a Category III AIF shall act in a fiduciary capacity towards its investors. The Sponsor appoints the Trustee for the Fund in order to safeguard the assets of the investors and also appoints an independent Investment Manager to take investment decisions on their behalf. It is very likely that appointment of such entities may result in potential conflicts of interest. 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.

5.16.5 Transparency:

All Category III 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

- A Category III AIF shall provide the following data to investors on a quarterly basis, within 60 days from end of the quarter:
    - Relevant financial information on investee companies
    - Material risks and risk management activities undertaken, for:
        - Concentration Risk at Fund Level
        - Foreign Exchange Risk at Fund Level

- Leverage Risk at Fund and Investee Company Levels
- Risk of Realization from the Exits made in Investee Company, at Fund and Investee Company Levels
- Strategy Risk at Investee Company level
- Reputation Risk at Investee Company level
- Extra-financial risks, including environmental, social and corporate governance risks, at fund and investee company levels.

- A Category III AIF shall report any significant change in the key Investment Management team, to the investors and SEBI.

- A Category III AIF shall also provide information to SEBI, when required, for systemic risk purposes, including risk identification, analysis and mitigation of systemic risk.

5.16.6 Valuation: [103] [104]

A Category III AIF shall carry out valuation of its investments as specified by SEBI from time to time. The Category III AIF shall ensure that calculation of the net asset value (NAV) is independent from the fund management function of the Fund and the NAV is disclosed to the investors at quarterly intervals for close-ended funds and at monthly intervals for open-ended funds. For the purpose of calculation of NAV, a Category III AIF shall undertake valuation of their investment in unlisted securities and listed debt securities by an independent valuer.

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 Category III 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 and has membership of Institute of Chartered Accountants of India or Institute of Company Secretaries of India or Institute of Cost Accountants of India 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 as may be specified by SEBI.

SEBI has prescribed a standardised approach to value the investment portfolio of a Category III AIF:

[103] Vide SEBI (Alternative Investment Funds) (Second Amendment) Regulations, 2023 w.e.f. November 1, 2023.
[104] SEBI Circular No. SEBI/HO/AFD/PoD/CIR/2023/97 dated June 21, 2023, with an effective date of November 01, 2023.

- Valuation of securities for which valuation norms have already been prescribed under SEBI (Mutual Funds) Regulations, 1996 shall be carried out as per the said Regulations.
- Valuation of other 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.
- The PPM of Category III AIFs shall contain details of the valuation methodology and approach adopted for each asset class of the scheme.

The investment manager shall be responsible for a true and fair valuation of the investments of the Category III AIF. In case the valuation policies and procedures of the Category III 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 Category III AIF scheme. In such circumstances, the Category III 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 Category III AIF scheme.
    - Details of changes in accounting practices/policies, if any, of the investee company and Category III AIF scheme.
    - Details of impact of the aforesaid changes in terms of valuation of the investments of the Category III AIF scheme.

5.16.7 Other Obligations:

Category III AIF Investment Managers shall be obliged to address all investor complaints, if any. All claims/disputes between investors and AIF or the Manager arising in relation to the activities of the fund or the Manager in the securities market shall be submitted to a dispute resolution mechanism that includes mediation and/or conciliation and/or arbitration, in accordance with the procedure specified SEBI. However, it is to be noted that if the AIF is established as a trust, then no loss or damage or expenses incurred by the Manager or its officers, including those in relation to resolution of claims or disputes of investors, shall be met out of the trust property.[105]

- The Fund shall lay down suitable procedures for resolution of disputes between the investors, Category III AIF, Investment Manager or Sponsor, through arbitration or other alternative dispute resolution mechanism.

- SEBI may call for any information from a registered Category III AIF, if required, for assessment of systemic risk or prevention of potential fraud. The Category III AIF, Sponsor or Investment Manager shall furnish the same within the specified time limit.

- The Investment Manager or Sponsor shall maintain records for a period of 5 years after the winding up of the funds, describing:
  - assets under management for the scheme/fund
  - valuation policies and practices for the scheme/fund
  - investment strategy
  - details of investors and their contribution;
  - rationale for investments made

5.16.8 Winding-up

A Category III AIF shall be wound-up in either of the following scenario:

- The tenure of the fund or scheme, as mentioned in the PPM, is over
- The opinion of the trustee or the trustee company, as the case may be, is to wind up the fund in the interest of the investors
- 75 percent of the investors, by value of their investment in the fund, pass a resolution at a meeting of unit holders that the Fund should be wound up
- SEBI directs the Fund to wind-up, in the interest of the investors

Additionally, if a Category III AIF is set-up as a company, it shall be wound-up in accordance with the provisions of the Companies Act, 2013. Similarly, if the Category III 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 a Category III 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. In all situations, SEBI and the investors must be informed about the circumstances leading to the decision of winding-up of the Category III AIF. From the date of intimation of winding-up to SEBI and investors, no further investments shall be made on behalf of the Category III AIF being wound-up.

The assets of a Category III 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 Category III AIF scheme, for fully liquidating the asset of such existing AIF scheme. In case the Category III AIF scheme is unable to liquidate some of its assets, in-specie

[105] Vide SEBI (Alternative Dispute Resolution Mechanism) (Amendment) Regulations, 2023 w.e.f. July 3, 2023.

distribution of such assets may be made to some 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.[106]

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. Sell its unsold/illiquid investments to a 'Liquidation Scheme' 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.[107]

'Liquidation Scheme' means a close-ended AIF scheme launched by a Category III AIF, 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.

Upon winding-up of the Fund, the Certificate of Registration shall be surrendered to SEBI.

5.17 Investor Charter[108]

Investor Charter is a brief document containing details of services provided to investors, details of grievance redressal mechanism, responsibilities of the investors etc., for ease of reference. The following information should be published in the Investor Charter:

- Vision and Mission Statement
- Details of business transacted by the Fund with respect to the investors
- Details of services provided to investors, such as:
    - On-boarding of investors
    - Obtaining investor consent for material changes to fund structure
    - Dissemination of financial information of Fund
    - Disclosures with respect to material risks associated with the fund and its portfolio investments
    - Intimation of any non-material changes in the operations of the fund
    - Grievance redressal
- Timelines of the activity/services provided to investors, such as:
    - Valuation related disclosures
    - Transparency related disclosures
    - Complaint handling related services
- Details of grievance redressal mechanism and how to access it
- Responsibilities of investors:

[106] Inserted by SEBI (Alternative Investment Funds) (Second Amendment) Regulations, 2023 w.e.f. June 15, 2023.
[107] SEBI Circular No.: SEBI/HO/AFD/PoD1/CIR/2023/098 dated June 21, 2023 on Modalities for launching Liquidation Scheme and for distributing the investments of AIFs in-specie.
[108] SEBI Circular No.: SEBI/HO/IMD/IMD-I/DOF9/P/CIR/2021/682 dated December 10, 2021 on Publishing Investor Charter and Disclosure of complaints by AIFs.

- To inform and educate investors
- To timely update KYC and information with the Intermediary
- To abide by the contribution agreement
- To use right financial intermediaries, consultants and advisors
- To maintain confidentiality of information

Category III AIFs are advised to take necessary steps to bring the Investor Charter to the notice of their investors in the following manner:

- In case of new schemes, disclose Investor Charter in the PPM;
- In case of existing schemes, as a one-time measure, disclose Investor Charter to the investors on their registered e-mail.

Additionally, data on investor complaints received against Category III AIFs and each of their schemes and redressal status thereof shall be disclosed in the following manner:

- For new schemes, as a separate chapter on its Investor Grievance Redressal in the PPM.
- For existing schemes, AIF should update the PPM within 1 month of end of each financial year and inform the investors and SEBI on a consolidated basis.

AIFs shall maintain investors' complaints data for: (a) each quarter, every year and (b) last three Financial Years from the date of submission. The data to be compiled within 7 days from the end of quarter. These disclosure requirements are in addition to the existing requirements pertaining to the investor grievance handling mechanism.

5.18 Compliance Test Reporting (CTR)

To ensure proper compliance and adherence with SEBI (Alternative Investment Funds) Regulations and related circulars, the manager of a Category III AIF must prepare a Compliance Test Report (CTR) as per the prescribed format.[109]

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 5.3.

[109] SEBI Circular No.: CIR/IMD/DF/14/2014 dated June 19, 2014 on Guidelines on disclosures, reporting and clarifications under AIF Regulations.

Table 5.3: 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 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 Category III AIF scheme has to be Rs. 20 crore.	Whether each scheme of the Category III AIF has corpus of at least Rs. 20 crore.
Minimum Investment Amount from Investors	Minimum investment amount from every investor should be Rs. 1 crore[110].	Whether the fund added any new investors and took investments worth less than Rs. 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 Rs. 10 crore, whichever is lower, in the Category III AIF.	Whether the Manager or Sponsor has a continuing interest in the Category III AIF.
Amount of contribution by the investment manager in the Category III AIF	Investments made by the manager needs to be disclosed to the investors.	Whether the Manager and Sponsor have disclosed their investments in the Category III AIF.
Number of investors in the Category III AIF	A Category III AIF cannot have more than 1000 investors in one single scheme.	Whether each scheme of the Category III AIF adheres to the regulation.

[110] Not applicable to Accredited Investors, as per SEBI (Alternative Investment Funds) (Third Amendment) Regulations.

CTR Disclosure Item	Regulatory Guidelines – Under SEBI (Alternative Investment Funds) Regulations	Disclosure to be made in CTR
Fund raising	A Category III AIF can raise funds only by way of a private placement mechanism.	Whether the Category III 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 material information about the Category III AIF.	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.	Whether the Category III 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.
Dematerialization of units issued	All AIF schemes shall issue units in dematerialised form.	Whether the Category III AIF has dematerialised its units and reporting the mechanism for transfer of its units in the PPM.
Investment Conditions and Restrictions	Compliance with investment conditions and restrictions on a Category III AIF.	Whether the Category III AIF has adhered to the investment restrictions relating to overseas investments, co-investments, concentration limits, investment in associates and temporary liquid assets.
Leverage and Prudential Norms	Compliance with permissible investments and prudential norms.	Whether the Category III AIF has engaged in leverage, derivative exposures and if there is a breach of leverage limits set forth under the Regulations.

CTR Disclosure Item	Regulatory Guidelines – Under SEBI (Alternative Investment Funds) Regulations	Disclosure to be made in CTR
General Obligations of the Fund	Compliance with general obligations and responsibilities of the Category III AIF.	Whether the Category III AIF has appointed a custodian as per the Regulations. 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 quarterly disclosures have been made on financial and operational risks, fees paid to the manager, legal actions and inquiries, breach of PPM provisions and change in control and key management team of the Category III AIF.
Calculation of NAV	NAV calculation should be independent from the fund management function and disclosed to investors. Valuation of assets as specified 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.	Whether the Category III AIF has ensured that the NAV calculation is independent from the fund management function, and is disclosed to investors at quarterly intervals for close-ended funds, and monthly intervals for open-ended funds. Whether a standardized approach for asset valuation is adopted, as specified by SEBI.
Extension of Fund Tenure	Fund tenure of a close-ended Category III AIF can be extended for up to 2 years after seeking approval from two-thirds of the	Whether the Category III AIF has extended the Fund tenure up to 2 years. Whether the Category III AIF has sought investor approval. If not, whether the Category III AIF has fully liquidated within

CTR Disclosure Item	**Regulatory Guidelines – Under SEBI (Alternative Investment Funds) Regulations**	**Disclosure to be made in CTR**
	unit holders by value of their investment.[111]	1 year following expiration of the fund tenure.
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 Category III 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 taking investor approval for winding-up.	Whether the Category III AIF has taken approval of 75 percent of the investors and is in best interest of the investors, as per opinion of the Trustee or SEBI.
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.	Whether the Category III AIF has taken approval of 75 percent of the investors for: • making in-specie distribution of unliquidated investments, or • selling unliquidated investments to a Liquidation Scheme.

[111] Large value funds for accredited investors may be permitted to extend its tenure beyond two years, subject to terms of the contribution agreement, other fund documents and conditions specified by SEBI – Inserted by SEBI (Alternative Investment Funds) (Third Amendment) Regulations

5.19 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.

Indian Government signed an Inter-Government Agreement (IGA) under the FATCA, on July 9, 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 in 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 Category III AIFs have been given additional due diligence requirements related to investor accounts, under Rules 114F to 114H of the Income Tax Rules, 1962. Category III 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 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 the Category III 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 Category III 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 Category III AIF to tax authorities. A Category III 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 30 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.

5.20 SEBI (Prohibition of Insider Trading) Regulations, 2015

The SEBI (Prohibition of Insider Trading) Regulations, 2015 seeks to prevent insider trading which erodes the confidence of the common investors in the securities markets. SEBI

(Prohibition of Insider Trading) Regulations is applicable to all listed companies, intermediaries and fiduciaries to the company.

As per the Prohibition of Insider Trading (PIT) Regulations, "insider" has been defined as any person who is: (i) a connected person, or (ii) in possession of or having access to unpublished price sensitive information.[112] A "connected person", in terms of the PIT Regulations, means any person, who is or has during the 6 months prior to a concerned transaction, directly or indirectly,

- been associated with the listed company, by reason of frequent communication with its officers; or
- being in any contractual, fiduciary or employment relationship; or
- being a director, officer or an employee of the company; or
- holds any position including a professional or business relationship, whether temporary or permanent, allowing access to unpublished price sensitive information.

Category III AIF can, therefore, be 'deemed to be a connected person', as specified in the PIT Regulations, on account of the fund having possible access to unpublished price sensitive information about any investee company or class of companies.

The PIT Regulations stipulates that no insider shall communicate, provide or allow access to unpublished price sensitive information, except in furtherance of business purposes, performance of duties or discharge of legal obligations. Unpublished price sensitive information is any information relating to a company or its securities, directly or indirectly, that is not generally available and which upon becoming generally available is likely to materially affect the price of the securities.[113] Such unpublished information includes:

- financial results
- dividends
- change in capital structure
- mergers, de-mergers, acquisitions, delisting, disposals and expansion of business
- changes in key managerial personnel

As the employees of the Category III AIF can invest in AIF schemes, with a minimum investment of Rs. 25 lakh, such employees may possess unpublished price sensitive information. The Board of Directors of such Category III AIFs must set an Internal Code of Conduct governing trading by their employees and other connected persons to ensure compliance under the PIT Regulations.

[112]Unpublished price sensitive information is any information relating to a company or its securities, directly or indirectly, that is not generally available to the public and which upon becoming generally available, is likely to materially affect the price of the securities.

[113] Generally available information" means any information that is accessible to the public on a non-discriminatory basis.

Insider shall not trade in securities that are listed or proposed to be listed on a stock exchange when in possession of unpublished price sensitive information. Exception to this regulation is when the transaction is:

- an off-market inter-se transfer between insiders along with timely disclosure to the company;
- done through block deal window mechanism;
- carried out pursuant to regulatory obligations;
- undertaken pursuant to exercise of stock options
- done by non-individual insiders, such as Institutions wherein:
    - the individuals in possession of unpublished price sensitive information were different from individuals taking trading decisions
    - appropriate and adequate arrangements were in place to ensure that no unpublished price sensitive information was communicated by individuals possessing the information to the individuals taking trading decisions
- done pursuant to a Trading Plan set up in accordance with the PIT Regulations. Such trading plan should be presented to the Compliance Officer for approval and adequate public disclosure must be made.

The Board of Directors or head(s) of organisation (in this context: Investment Manager or Sponsor of the Category III AIF), in possession of unpublished price sensitive information, shall ensure that a structured digital database is maintained internally, which contains:[114]

- the nature of unpublished price sensitive information shared
- the names of such persons who have shared the information
- the names of such persons with whom the information is shared along with their Permanent Account Number (PAN) or any other identifier authorized by law where PAN is not available.

Such database shall not be outsourced and shall be maintained internally, with adequate internal controls and checks such as time stamping and audit trails to ensure non-tampering. The database shall be preserved for a period of not less than 8 years after completion of the relevant transactions, or till the completion of SEBI proceedings in respect of such transactions, if any.

The Compliance Officer and Directors of the Category III AIF should be responsible to frame a 'Code of Conduct', which details out the policies and procedures to be followed by such fund in order to deal with price sensitive information and reporting of transactions done by 'connected person', 'deemed to be connected person' and immediate relatives of such persons. The Code of Conduct shall be applicable to Promoters, Directors, Chief Executive

[114] Vide SEBI (Prohibition of Insider Trading) (Amendment) Regulations, 2020 w.e.f. July 17, 2020.

Officer (CEO), employees up to two levels below the CEO, support staff, material subsidiaries and affiliate companies of Category III AIF, such as the Asset Management Company, Sponsor and Trustee Company.

The PIT Regulations have set forth minimum standards for the Code of Conduct, to regulate, monitor and report trading by designated persons, and their immediate relatives, of a Category III AIF (a SEBI registered intermediary). All information shall be handled within the fund on a need-to-know basis and no unpublished price sensitive information shall be communicated to any person, except in furtherance of legitimate purposes. The Code of Conduct shall contain norms for *Chinese Wall* procedures and shall stipulate sanctions and disciplinary actions, including wage freeze, suspension, recovery, etc., that may be imposed, by the Category IIIAIF, in case of non-compliance. In the event of any violation of the PIT Regulations, profits derived out of such trades should be collected and credited to the Investor Protection and Education Fund, established by SEBI.

The Code of Conduct should stipulate a reporting format for making pre-clearance applications, reporting of trades executed and level of holdings in securities. Designated persons of the Category III AIF, and their immediate relatives, shall not trade in securities when the trading window is closed. Trading by designated persons shall be subject to pre-clearance by the Compliance Officer of the Category III AIF, if the value is above the pre-determined threshold limit. Pre-cleared trades should be executed within 7 trading days of approval, failing which fresh pre-clearance is required.

Every Category III AIF should implement an institutional mechanism for prevention of insider trading. The fund should build an adequate and effective internal control system, to ensure compliance with the requirements given under the PIT Regulations:

- All employees who have access to unpublished price sensitive information should be identified as designated persons.
- All price sensitive information shall be identified and its confidentiality shall be maintained.
- Adequate restrictions shall be placed on communication or procurement of unpublished price sensitive information.
- Lists of all employees and other persons with whom unpublished price sensitive information is shared shall be maintained and confidentiality agreements shall be signed, or notice shall be served, to all such employees and persons.
- Conduct periodic process reviews, to evaluate effectiveness of internal controls.
- Formulate written policies and procedures for inquiry in case of leak or suspected leak of unpublished price sensitive information.
- Frame a whistle-blower policy and all the employees should be made aware of such policy.

5.21 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 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.

Regulatory Oversight:

The PML Rules requires the reporting entities i.e. banks, financial institutions and intermediaries, such as Category III AIFs to maintain records of the following transactions:

- All cash transactions of the value of more than Rs. 10 lakh, or its equivalent in foreign currency.
- All series of cash transactions, integrally connected to each other and individually valued below Rs. 10 lakh, or its equivalent in foreign currency, but have taken place within a month and the monthly aggregate exceeds the threshold of Rs. 10 lakh or equivalent in foreign currency.
- All transactions involving receipts by a non-profit organization (NPO) of value more than Rs. 10 lakh or its equivalent in foreign currency.
- All cross-border wire transfers of a value of more than Rs. 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 Category III AIFs, perform client due diligence, as per the Prevention of Money Laundering (Maintenance of Records) Rules.

The Category III 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
- evaluate the risks associated with Politically Exposed Persons (PEPs) and implement necessary measures to prevent money laundering and terrorist financing

Every Category III 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 Category III 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 Category III 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 Category III AIF must update the same on the CKYCR portal. Further, Category III AIFs are permitted to share KYC data with customer consent, provided it is done securely and in compliance with data protection laws.

If the Category III AIF has Foreign Portfolio Investors (FPIs), the fund should adopt the risk-based KYC framework, applicable to such investors. The Category III 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 Category III 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 25 percent 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 Category III AIF. In case any litigation is pending, these records should be maintained till the completion of the proceedings.

Further, a Category III AIF must ensure that appropriate steps are taken to recognize and report suspicious transactions to the Director – Financial Intelligence Unit (FIU) - India.[115] 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.

Any suspicious transaction shall be immediately notified to the Money Laundering Control Officer or a designated officer with the Category III AIF. Category III 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 Category III 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,

[115] 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.

not fall within the definition of NPO, under PML 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 a Category III AIF, from a family trust, would not be covered under the PML 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.

5.22 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 7, 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 recognised 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.

The Indian FDI Policy allows foreign investment in Indian Companies through:

- Foreign Direct Investment (FDI)
- Investments made by Foreign Portfolio Investors (FPIs)
- Investments made by Foreign Venture Capital Investors (FVCI)
- Investments in investment vehicles, such as a Category III AIF

Foreign investors may make purchase or redemption of units issued by an Indian Category III AIF, 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. 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 a Category III 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 Category III 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.

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.

A Category III 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 RBI. Furthermore, a Category III 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 Category III AIFs are mandatorily required to file the SMF from September 1, 2018. With the new SMF manual and FIRMS framework, all filings will need to be completed by the Category III AIF, and verified, scrutinized and acknowledged or rejected by their respective Authorized Dealer (AD) Banks.

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.

Some important reforms for foreign investment in a Category III AIF are as under:

- **Applicability of Downstream Investment conditions**:

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. Generally and ordinarily, such investments made by the Investment 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, a downstream Investment made by a Category III AIF shall be regarded as an indirect foreign investment only if, either the sponsor or the investment manager of the Category III AIF is not Indian ‘owned and controlled’.[116] ‘Control’ of the AIF should be in the hands of the sponsor or investment manager of the Category III AIF for the investment to be termed as an indirect foreign investment. “Owned and Controlled” does not take only the extent of foreign investment in the corpus of the Category III AIF, to determine as to whether downstream investment of the Category III AIF is an indirect foreign investment or not.

[116] defined in Foreign Exchange Management (Manner of Receipt and Payment) (Amendment) Regulations, 2019

The RBI Notification allows a Foreign Investor to invest in an Indian Category III 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. With such relaxation of norms and FDI restrictions for foreign investors looking to invest in Indian Category III AIFs, the Indian Alternative Investment Market has seen an unprecedented growth in size. The payment for the units of a Category III 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.[117] A Category III AIF which is "owned and controlled" by a non-Indian sponsor or investment manager, downstream Investments made by such Category III AIF must comply with the sectoral caps, as applicable to the sectors in which the downstream investment is made as per the FDI Policy.

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.[118]

- **Overseas Investment by a Category III AIF registered with SEBI:**

All AIFs, including Category III AIFs can invest in securities issued by companies incorporated outside India, with the following conditions:

- Investments in equity or equity-linked securities issued by offshore companies are subject to a maximum limit of USD 1500 million across all registered AIFs. Allocation of this limit will be done on first-come-first served basis. An Offshore Company is a foreign company whose shares are not listed on an Indian Stock Exchange.[119]
- A Category III AIF desirous of making such offshore investments shall submit a proposal to SEBI for approval. SEBI will grant separate overseas investment limits to the applicable AIFs.
- A Category III 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.

- Overseas Investment shall not exceed 25 percent of the Investible Funds of the Category III AIF or its scheme.

[117]specified in Foreign Exchange Management (Deposits) Regulations, 2016
[118] As per Foreign Exchange Management (Mode of Payment and Reporting of Non-Debt Instruments) Regulations, 2019
[119] Vide SEBI Circular No.: SEBI/HO/IMD/DF6/CIR/P/2021/565 on "Enhancement of overall limit for overseas investment by Alternative Investment Funds (AIFs)/Venture Capital Funds (VCFs)"

Further, SEBI has notified the guidelines for overseas investment by all AIFs. The same has been discussed in section 5.16.1 of this Chapter.

5.23 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 Rs. 50 crore. ICDR Regulations have different impacts for a Category III 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 of the post-issue paid-up share capital of 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 is proposed to be utilised for capital expenditure, then the lock-in period for minimum promoter contribution shall be 3 years.[120] 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.[121] A Category III AIF is not deemed to be a promoter or to form part of the promoter

[120] As per Securities and Exchange Board of India (Issue of Capital and Disclosure Requirements) (Third Amendment) Regulations, 2021
[121] Regulation 22 of the SEBI (Issue of Capital and Disclosure Requirements) Regulations, 2018

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 is proposed to be utilised for capital expenditure, then the lock-in period for such shares shall be 1 year. 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.

- **Preferential Allotment of Shares in a QIP:**

A Category III 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. QIBs 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 a Category III AIF, in a preferential allotment shall be subject to a lock-in for a period of 6 months from the date of allotment of shares. In case majority of the proceeds from such preferential allotment is proposed to be utilised for capital expenditure, then the lock-in period for such shares shall be 1 year

- **Sale of Shares by a Category III AIF, 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 year.[122] Hence, a Category III AIF must ensure that their exit strategy from an investee company takes into consideration various lock-in conditions. A Category III 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.

[122] As per Securities and Exchange Board of India (Issue of Capital and Disclosure Requirements) (Third Amendment) Regulations, 2021

SEBI made it mandatory for the offeror, i.e. the Category III 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.

Chapter 5: Sample Questions

1. **Which of the following entity is least likely to be a permissible legal structure, seeking registration as a Category III AIF under the SEBI (Alternative Investment Funds) Regulations?**

    a. Limited Liability Partnership (LLP)
    b. Company
    c. Trust
    d. **Proprietorship**

2. **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

3. **The leverage taken by a Category III AIF shall not exceed 2 times of_____________ of the fund.**

    a. **Net Asset Value**
    b. Total Capital Contribution
    c. Total Investments
    d. Gross Asset Value

4. **A Category III AIF can invest up to _____ of its investible funds in one single investee company.**

    a. 20 percent
    b. **10 percent**
    c. 25 percent
    d. 5 percent

5. **SEBI provides only observations on the PPM submitted to them and does not approve the document. State whether True or False.**

    a. **True**
    b. False

Chapter 6: Fees Structure, Fund Performance and Benchmarking

LEARNING OBJECTIVES:
After studying this chapter, you should know about: • Fee structure of a Category III AIF • Various performance metrics (Return metric/ Risk metric/ Risk-adjusted Return metric) • Role of performance benchmarking

6.1 Fee Structure of a Category III AIF

6.1.1 Management Fees and Other Expenses

A Category III AIF is a pooled investment vehicle, which collects capital contributions from investors to invest the pooled capital in eligible securities or derivative contracts, as per the investment strategy of the Fund. As discussed in Unit 4, a Category III AIF appoints an Investment Manager, who provides fund management services using their investment knowledge, market experience and industry exposure, with an aim to generate profits for the fund. In return of such services, the Manager charges an investment management fee to the Category III AIF, known as **Management Fees**. Management Fees are allocated to every investor on a pro-rata basis, based on their value of investment in the fund.

Management Fees are charged as a fixed percentage, ranging from 1 percent to 2.5 percent, of the Gross Net Asset Value of the fund. The rates at which the fees are charged are pre-determined and fixed before the launch of the scheme and mentioned in the placement memorandum.

It is important to note that:

- Management Fee is paid to the Manager, irrespective of any future gains or losses made by the Fund. Management Fees are paid for the fund management services provided by the Manager and not for profit-generation. The Management Fees shall accrue from the date of the First Close, up to the date when the Category III AIF is dissolved.
- Management Fees are to be paid on a periodic basis, generally monthly or quarterly, as specified in the private placement memorandum issued by the fund. Management Fees are generally paid in arrears, within 14 days after the relevant valuation day, when the Gross Net Asset Value (GNAV) of the Category III AIF is computed.

Example 1: Computation of Management Fees:

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

Total Capital Contributions	Rs. 50 crore

Gross NAV - at end of Year 1	Rs. 58 crore
Gross NAV - at end of Year 2	Rs. 65 crore
Management Fees (excl. GST @ 18%)	1.5%

Calculate the Management Fees payable by the Fund, in Year 1 and Year 2.

Solution:

Management Fees in Year 1:

Gross NAV of the Fund at end of Year 1 – Rs. 58 crore (given)

Management Fees:

1.5% * Rs. 58 crore	Rs. 87 lakhs
Add: GST – 18% * Rs. 87 lakhs	Rs. 15.66 lakhs
Total Management Fees Payable	**Rs.102.66 lakhs**

Management Fees in Year 2:

Gross NAV of the Fund at end of Year 2 – Rs. 65 crore (given)

Management Fees:

1.5% * Rs. 65 crore	Rs. 97.50 lakhs
Add: GST – 18% * Rs. 97.50 lakhs	Rs. 17.55 lakhs
Total Management Fees Payable	**Rs. 115.05 lakhs**

Note:

- Management Fees are not charged on the Committed Capital and Capital Contributions of the Fund. Management fees are computed on the GNAV of the fund, as shown in the example.

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

Incentive Fee is charged as a percentage of the incremental return earned by the Category III 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.

Further, it is important to note that:

- Incentive fees are paid as an incentive to the Manager to generate profits for the fund. This helps to align the interest of the Manager with the interest of the fund and encourages the Manager to seek best execution of investments for the interest of the investors in the fund.

- Incentive Fees are computed and payable to Manager, after completion of the stated fund tenure, in case of closed-ended funds.

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 and High-Water Mark 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 the Category III 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:**

The 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 2 percent or 2.5 percent of total capital commitments raised by the fund. The Set-up costs are incurred towards any offering costs, registration and compliance costs, fees and commissions to be paid to intermediaries, 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 the entire life of the Category III 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:**

  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;
    - Interest on borrowings, if any;
    - 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 bankers, 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:**

Category III AIF shall bear and pay all transaction expenses 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.

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:

- Directors' fees and Trusteeship Fees
- Professional fees
- Administrative Costs and Office Expenses
- Out-of- pocket expenses incurred by the Investment Manager
- Fees to third parties such as Merchant Bankers, Custodians, Fund Administrators, Distributors, 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.

6.1.2 Hurdle Rate

The investors in the Category III 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 Category III 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. Incentives 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 Category III AIF, on a pro-rata basis based on their value of investment in the fund.

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 Incentive Fees. If the Hurdle Rate is high, the Investment Manager will not be able to generate a 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 a Category III AIF is critical and involves serious negotiations between the Investment Manager and investors in the fund.

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

Example 2: Computation of Hurdle Rate and Incentive Fees:

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

Committed Capital	Rs. 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)	Rs. 1.25 crore
Yearly fund expenses	Rs. 30 lakhs
Hurdle Rate	10%
Gross Net Asset Value (at end of Year 1)	Rs. 58 crore

Gross Net Asset Value (at end of Year 2)	Rs. 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 (Rs.)**	**Rs. (Per Unit)**
Called-up Capital	50,00,00,000	1000.000

Particulars	**Year 1**		**Year 2**	
	Amount (Rs.)	**Rs. (Per Unit)**	**Amount (Rs.)**	**Rs. (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 [15%*C]	**21,35,100**		**41,99,250**	

From the table above:

- Initial Set-up Cost of Rs. 1.25 crore is amortized over 5 years. Hence, set-up costs charged in Year 1 will be Rs. 25 lakh. (Rs. 1,25,00,000/5)
- Management Fees is computed in the similar manner as computed in Example 1.
- 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.

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, 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 – Rs. 6,35,100
        - Year 2 – Rs. 8,69,250

6.1.3 High-Water Mark

As discussed above, Incentive Fees are payable to the Investment Manager as an incentive to generate profits or 'Alpha' for the Category III 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 III 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 Category III AIF, and to safeguard the interest of investors in the Category III AIF, 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 Category III 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.

If the High-Water Mark of the Category III 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 Category III AIF – Fund ABC.

Example 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.

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

Committed Capital	Rs. 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)	Rs. 1.25 crore
Yearly fund expenses	Rs. 30 lakhs
Hurdle Rate	10%

Particulars	**Best Case Scenario**	**Worst Case Scenario**
Gross Asset Value (at end of Year 1)	Rs. 58 crore	Rs. 55 crore
Gross Asset Value (at end of Year 2)	Rs. 65 crore	Rs. 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 (Rs.)**	**Rs. (Per Unit)**
Called-up Capital	50,00,00,000	1000.000

Particulars	**Year 1**		**Year 2**	
	Amount (Rs.)	**(Per Unit)**	**Amount (Rs.)**	**(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 Rs. 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.

- 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 (Rs.)	Rs. (Per Unit)
Called-up Capital	50,00,00,000	1000.000

Particulars	Year 1		Year 2	
	Amount (Rs.)	(Per Unit)	Amount (Rs.)	(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 Rs. 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 Rs.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.

6.1.4 Comparative Analysis: Fee Structure

Fee Structure of Mutual Funds v/s Category III AIFs

As discussed above, the primary components of the Fees charged by a Category III AIF are:

1. Management Fees
2. Incentive Fees

A Mutual Fund is also a pooled investment vehicle which collects capital contributions, from retail investors and institutional investors, to invest the pooled capital in equity or debt securities for the time horizon mentioned in the offer document of the Fund. The Mutual Fund also appoints an Investment Manager, who provides fund management services to the Fund using their investment knowledge, market experience and industry exposure.

The Fee Structure for Mutual Funds is calculated using the Total Expense Ratio (TER), as per SEBI (Mutual Funds) Regulation, 1996. The fees charged by Mutual Fund include many components, such as:

- Investment Management Fees
- Advisory Fees
- Registrar and Transfer Agent Fees
- Legal and Audit fees
- Distributor Commissions and Marketing Expenses
- Transaction costs
- Custodian Fees
- Operational costs
- Insurance costs
- On-going service charges and other costs

All such expenses involved in the management of mutual funds are together known as the Total Expense Ratio (TER), which denotes the fee charged by the mutual fund scheme to manage the investments on behalf of the investors. The TER is expressed as a percentage of the assets under management (AUM) of the mutual fund.[123] The Net Asset Value (NAV) of the

[123] Asset under management (AUM) of the mutual fund scheme is calculated by taking the average of its daily net assets, in the reporting period. TER Limit is computed based on the AUM calculated.

Fund is reported after deduction of the TER from the Gross Assets of the Fund, as on a particular date.

SEBI, vide its various circulars, has fixed the upper cap of the TER chargeable by the mutual funds to protect the interests of the investors. TER Limit includes all expenses of the Fund, including Advisory Fees and Investment Management Fees. The Investment Manager is not permitted to charge any additional fee above the prescribed TER Limits. Permissible expenses beyond the TER Limit of the mutual fund scheme are mentioned in the SEBI (Mutual Funds) Regulations, 1996.

SEBI has put the specified limits on all the expenses and fees charged by the mutual fund, including advisory fees and investment management fees. TER limits serve as a cap on the fees charged by the mutual fund scheme, in order to align the interest of the Investment Manager with the investors in the mutual fund scheme. However, such restrictions result in limits on the advisory fee or management fee income for the Investment Manager of the Mutual Fund, which practically comes to less than 1.5 percent of the Assets under Management (AUM) of the Fund. In comparison to this, a Category III AIF can charge a Management Fee of up to 2.5 percent of the Total Asset Value of the Fund.

In addition to the cap on the investment management fees and advisory fees, the Investment Manager is prohibited from charging Incentive Fees, which is a share in the profit generated by the mutual fund scheme. Such restrictions are placed in order to limit the risk and leverage taken by the Investment Manager of the mutual fund, as well as safeguard the interests of retail investors with a limited risk appetite. However, institutional investors and High Net-worth Individual (HNI) investors in a Category III AIF have adequate risk appetite to invest in risky securities and take leverage. Hence, a Category III AIF Investment Manager is permitted to invest in risky securities and take leverage.

Other operating expenses, third party fees, marketing expenses, custodian fees, registrar fees and transaction costs are covered in the TER limit for a mutual fund scheme, unless otherwise specified by the SEBI (Mutual Funds) Regulations, 1996. This further limits the amount that can be charged as advisory fees or investment management fees, by the Investment Manager of a mutual fund. In comparison to this, Investment Manager of a Category III AIF can charge Management Fees, in addition to operating expenses, transaction costs, distribution costs, custodian fees, trusteeship fees and administration costs incurred by the fund. Table 6.1 summarizes the differences in Fees Structure of Category III AIF and Mutual Funds:

Table 6.1: Fees Structure – Mutual Funds v/s Category III AIFs

Fee Component	**Mutual Fund**	**Category III AIF**
Management Fees	TER limits for a mutual fund scheme place restrictions on the investment management fees charged by the Investment Manager of a mutual fund.	Management Fees can be charged at the discretion of the Investment Manager, usually up to 2.5% of the Total Assets of the Fund as per industry practice, without restrictions from SEBI.

	TER for a mutual fund is taken as a percentage of "Assets under Management" of the mutual fund scheme.	Management Fees is computed as a percentage of "Total Assets" of the Category III AIF, which is before the deduction of all fund liabilities and expenses.
Incentive Fees	Investment Managers are not permitted to charge Incentive Fees.	Investment Managers are permitted to charge Incentive Fees, usually up to 20% of Incremental Returns of the Fund as per industry practice, without restrictions from SEBI.
Other Operating Expenses	All operating expenses and transaction costs are covered in the TER limit, unless otherwise specified by SEBI.	Management Fees is charged in addition to all operating expenses and transaction costs incurred by the fund. The operating expenses are usually capped by the Category III AIF, up to 0.5% of AUM. Operating Expenses are charged based on actuals, up to the capped limit.

In 2019, SEBI had amended the SEBI (Mutual Funds) Regulations to reduce the TER Limits on all mutual fund schemes. This has indirectly reduced the limit on the investment management fees and advisory fees to be charged by Investment Managers of mutual funds.

As a result of the reduction in the TER limit for mutual fund schemes, many mutual fund managers have now launched their own Alternative Investment Funds (AIFs), based on their industry experience and industry network.

Fee Structure of PMS v/s Category III AIFs

Portfolio Management Services (PMS) is not a pooled investment vehicle like AIFs. It is a customized service offered to high net-worth investors and institutional investors. In order to be eligible to provide services under PMS, the Portfolio Manager must have a minimum Net worth of Rs. 5 crore and collect a minimum investment of Rs. 50 lakh from a single investor. The Portfolio Manager invests capital on behalf of their investors, or provides investment advice to the investors depending upon the type of the portfolio management services opted by the investor, as per the SEBI (Portfolio Managers) Regulations, 2020.

Portfolio Managers of PMS also charge Management Fees and Performance Fees to their investors. There is, however, no limit on fees or benchmark rates set by the regulator on this behalf, as in the case of the mutual funds. The fee charged by the Portfolio Manager is as per the agreement with the investors for rendering portfolio management services. The Portfolio Manager can charge customized fees to the investors, based on the investor profile, targeted market segment, tenure of the fund and other macro-economic factors or risks.

All investors are provided the flexibility to choose the fee structure of their PMS account, unlike investors in a Category III AIF, wherein one class of investors are charged the same fee structure as determined by the Investment Manager. For example, a Portfolio Manager can charge 2.5 percent Management Fees to one class of investors and charge 1 percent Management Fees plus 15 percent Incentive Fees to a second class of investors. In this case, the Portfolio Manager can give an option to the prospective investors to choose between a "fixed fee" and "fixed plus variable fee".

Fee Structures of a Category III AIF and PMS are almost similar, with a few notable differences, as follows:

- Category III AIF managers do not provide an option to the prospective investors, to choose between two different fee structures. Every class of units issued by a Category III AIF has a pre-determined fee structure.

- Category III AIF managers typically do not charge a higher Management Fees and Incentive Fees, as compared to portfolio managers. Portfolio Managers may charge Management Fees ranging from 2 percent to 3 percent of total assets and Incentive Fees up to 40 percent of the profits earned in the client account. This fee structure mainly depends on the terms of subscription agreement signed with the investors.

Apart from Management Fees and Incentives Fees, both AIF and PMS charge other operating expenses and costs to the investors. However, in the case of the PMS, SEBI has provided more restrictions as compared to Category III AIFs, in the SEBI (Portfolio Managers) Regulations, 2020 on such additional fees charged by the PMS, such as Distribution Fees, Expenses, Exit Loads and Upfront Fees:

- A Portfolio Manager is banned from charging upfront fees, such as Registration Fees or Subscription Fees, to the investors directly or indirectly. This enhances transparency and accountability of the Portfolio Manager and Distributors.

- Operating Expenses, other than brokerage, charged by the PMS shall not exceed 0.5 percent every year, on the investor's average daily AUM. Brokerage fees should be charged at actuals and disclosed periodically to the investors.

- Exit Load can be charged to investors on the amount redeemed at maximum 3 percent if investments are redeemed in the first year, maximum 2 percent if investments are redeemed in the second year and maximum 1 percent if investments are redeemed in the third year of the PMS. No Exit Load can be charged subsequently to investors, after the end of third year of the PMS.

- The PMS should adopt a full-trail commission method for paying distribution fees to PMS distributors, similar to the method adopted for the mutual fund industry. This means that distributors' commission shall not be paid at the time of investor's investment (akin to mutual fund subscription to units), but paid subsequently every Quarter or other periodic time frame till the investor exits the PMS. Full-trail commission ensures that the Portfolio Manager, Distributors as well as Investors stay invested with the PMS for a long-term and the interests are aligned.

6.1.5 Gross (Pre-fees) and Net (Post-fees) Returns of a Category III AIF

A high pay-out of the Incentive Fees can substantially impact the Net Return earned by the investors. A Category III AIF, making a high pay-out of Incentive Fees, will deliver decreasing Net Return on Investment, to the investors. Hence, investors should check the quantum of incentive fee being charged by the Investment Manager, for every class of units being issued by the Category III AIF.

It is important to note that:

- Pre-fees return, or the gross return on investment, is calculated using the Gross Asset Value of the Category III AIF. Such return is the gross return earned on investments, before deducting the fund expenses, costs, management fees and incentive fees.

- Post-fees return will be calculated on the following two parameters:
    - **Net Return (Pre-Incentives)**: This return is calculated using the Net Asset Value of the Category III AIF, after deducting the fund expenses, costs and management fees, but before deducting the incentive fees.
    - **Net Return (Post-Incentives):** This return is calculated using the Net Asset Value of the Category III AIF, after deducting the fund expenses, costs, management fees as well as the incentive fees.

The other common issue when computing Gross return and Net return is the impact of taxes paid by the Category III AIF, if any. The taxation of pre-fees return and post-fees return is discussed in detail in Unit 9.

Let us understand the importance of Incentive Fees and calculate Pre-fees Return and Post-fees Return for investors, by continuing our example for Category III AIF – Fund ABC.

Example 5: Pre-Fees and Post-Fees Return:

Same scenarios are taken for computation of Pre-fees Return and Post-fees Return:

- **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.

Year 1: Data from the previous Examples

Particulars	Best-case Scenario		Worst-case Scenario	
	Amount (Rs.)	NAV per unit	Amount (Rs.)	NAV per unit
Gross Asset Value	Rs. 58,00,00,000	1160.000	Rs. 55,00,00,000	1100.000
NAV: Pre-incentives	Rs. 56,42,34,000	1128.468	Rs. 53,47,65,000	1069.530
NAV: Post-incentives	Rs. 56,20,98,900	1124.198	Rs. 53,47,65,000	1069.530

Year 2: Data from the previous Examples

Particulars	Best-case Scenario		Worst-case Scenario	
	Amount (Rs.)	NAV per unit	Amount (Rs.)	NAV per unit
Gross Asset Value	Rs. 65,00,00,000	1300.000	Rs. 54,00,00,000	1080.000
NAV: Pre-Incentives	Rs. 63,29,95,000	1265.990	Rs. 52,49,42,000	1049.884
NAV: Post-Incentives	Rs. 62,87,95,750	1257.592	Rs. 52,49,42,000	1049.884

Solution:

Returns are calculated, based on per unit values in the table.

Year 1: Comparison of Pre-fees and Post-fees Return

Particulars	Best-case Scenario		Worst-case Scenario	
	NAV per unit (Rs.)	Return (%)	NAV per unit (Rs.)	Return (%)
Initial Investment	1000.000		1000.000	
Gross Asset Value	1160.000	16.00%	1100.000	10.00%
NAV - Pre-Incentives	1128.468	12.85%	1069.530	6.95%
NAV - Post-Incentives	1124.198	12.42%	1069.530	6.95%

Year 2: Comparison of Pre-fees and Post-fees Return

Particulars	Best-case Scenario		Worst-case Scenario	
	NAV per unit (Rs.)	CAGR Return (%)*	NAV per unit (Rs.)	CAGR Return (%)
Gross Asset Value	1300.000	14.02%	1080.000	3.92%
NAV - Pre-Incentives	1265.990	12.52%	1049.884	2.46%
NAV - Post-Incentives	1257.592	12.14%	1049.884	2.46%

*Box 6.1 provides the formula for computing CAGR.

Box 6.1: CAGR Computation

Compounded Annual Growth Rate (CAGR) is the measure of the annual growth rate of the fund, after accounting for the effect of compounding. The CAGR for the fund is computed using the following formula:

$$CAGR = \left[\frac{Ending\ Value}{Beginning\ Value}\right]^{\frac{1}{n}} - 1$$

where:
Ending Value - NAV of Fund ABC after Year 2
Beginning Value - Initial NAV of Fund ABC, at the beginning of Year 1, i.e. Rs. 1000
n - Total number of years for which the investment was made, i.e. 2 years

From the tables above:

- Initial Investment in Year 1 is the initial corpus of Rs. 50 crore, which is subscribed through 5 lakh units at an NAV of Rs. 1,000.

- NAV – Pre-Incentives is computed after reducing the Fund Expenses such as Initial Set-up Cost, Yearly Expenses and Management Fees. All the above mentioned expenses are fixed expenses and to be borne by all the investors, on a proportionate basis.

- NAV – Post-Incentives is computed after reducing the Incentive Fees computed for that year.

Conclusion:

- On comparison of Pre-fees and Post-fees returns in the Best-case scenario:

    - In Year 1, it is observed that the fund generated a return of 16.00% on a gross-basis, which is exceptional. However, due to high fixed costs, fees and expenses incurred in Year 1, the Net Return (Pre-Incentives) was dropped to 12.85%. The Incentive Fees will be computed for Year 1, on account of the Incremental Return earned by the Investment Manager in that year, which resulted in further drop of the Net Return (Post-Incentives) to 12.42%.

    - In Year 2, the investment manager had not performed well compared to performance in Year 1. This can be observed from the changes in Gross Asset Value of the fund itself. Gross Asset Value at the end of Year 1 was Rs. 58 crore, while the Gross Asset Value at the end of Year 2 was Rs. 65 crore. The investment manager generated a marginally lower return in Year 2, and the Compounded Annual Growth Rate (CAGR) return of the fund over two years dropped to 14.02% on a gross-basis. Similarly, the Net Return (Pre-Incentive) dropped to 12.52% and the Net Return (Post-Incentive) dropped to 12.14%, when computed on a CAGR basis.

  - It may be noted that the Incentive Fees is not be payable to the Investment Manager, before end of the fund tenure.

- On comparison of Pre-fees and Post-fees returns in the Worst-case scenario:

  - In Year 1, it is observed that the fund generated a muted return of 10.00% on a gross-basis. On account of the high fixed expenses of the fund, the Net Return (Pre-Incentive) was only 6.95%. Since the Net Return (Pre-Incentive) was less than the Reference Hurdle, the investment manager is not eligible for any Incentives Fees and hence, the Net Return (Post-Incentive) was also 6.95% only.

  - In Year 2, the performance of the investment manager had worsened, as observed from the changes in Gross Asset Value of the fund. Gross Asset Value at the end of Year 1 was Rs. 55 crore, while the Gross Asset Value at the end of Year 2 was Rs. 54 crore. The investment manager generated a negative return in Year 2, and the CAGR return of the fund over two years dropped to 3.92% on a gross-basis. In this case, the Investment Manager is not eligible for an Incentive Fees, as the NAV is below the Reference Hurdle as well as the High-Water Mark. Hence, the Net Return (Pre-Incentive) is equal to the Net Return (Post-Incentive), which has significantly dropped to a mere 2.46%, when computed on a CAGR basis.

- The comparison of Best-case Scenario Returns and Worst-case Scenario Returns highlight the importance of every constituent in the Fee Structure of a Category III AIF, being Management Fees, Incentive Fees and the additional Fixed Costs incurred by the Fund.

The above return calculations are made before taking into account the treatment of Direct Taxes, on the business income and capital gains generated by the Fund. The Net Return to the Investors is calculated based on the Post-Tax NAV, which is distributed to the investors.

6.2 Fund Performance Measurement Tools

Fund performance is most actively monitored by all the stakeholders of a Category III AIF, being the investment manager, investors, sponsor, custodian, 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 Category III AIFs in the market and fund allocation. The Category III 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 Category III AIF investments are subject to market risks. Box 6.2 provides a brief overview on the Global Investment Performance Standards followed by AIFs worldwide.

Box 6.2: 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 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. A Category III 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 valuation 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.

6.2.1 Return Metrics

6.2.1.1 Internal Rate of Return

Internal Rate of Rate (IRR) is the return based on timing of the cash flows generated by the Category III 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. IRR is important for computing fund performance, as most Category III AIFs are illiquid in nature and hence, return generated by the Category III AIF should be computed on a yearly basis, based on the time periods for which capital was invested in the Fund.

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.

For understanding Gross IRR and Net IRR concepts, let us continue with the example of Category III AIF – Fund ABC:

Example 6: Gross IRR and Net IRR:

Category III AIF - Fund ABC is launched on January 01, 2019. Following are the details:

Committed Capital	Rs. 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)	Rs. 1.25 crore
Yearly fund expenses	Rs. 30 lakhs
Hurdle Rate	10%
Incentive Fees	15%
Long-term Capital Gain Tax on Distributions	11.96%
Investment Strategy	Buy-and-Hold

The Fund follows a Buy-and-Hold strategy. As per this strategy, all the assets of the fund are reinvested in the next year and net assets of the fund are distributed, at liquidation.

Same 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	Rs. 58 crore	Rs. 55 crore
Gross NAV – as on December 31, 2020	Rs. 65 crore	Rs. 54 crore
Gross NAV – as on December 31, 2021	Rs. 77 crore	Rs. 59 crore
Gross NAV – as on December 31, 2022	Rs. 90 crore	Rs. 65 crore
Gross NAV – as on December 31, 2023	Rs. 115 crore	Rs. 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 Fund ABC follows a Buy-and-Hold Strategy, 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

(Rs. 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)
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**

From the above table, we have calculated the NAV (Pre-incentives) for all five years in the similar manner, as discussed earlier. It can be observed that the Incentive Fees pay-out is made only in the last year of the Fund, after taking into account the Reference Hurdle and High-Water Mark for last year. In this case, most Category III AIF Managers consider paying Incentive Fees on the difference between the NAV (Pre-incentives) and the Hurdle Rate, without considering the High-Water Mark. However, for the interest of investors, the Incentive Fees must be paid after taking into account the Reference Hurdle as well as the High-Water Mark for last year of the fund scheme.

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, as per the buy-and-hold strategy of the fund. 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 (Rs.)
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 Rs. 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:

(Rs. 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)
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 by the Category III AIF, 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:

(Rs. 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					-
Incentive Fees					-
Net NAV (Pre-tax)					**682110.00**
Tax @ 11.96% (on difference of NAV over Rs. 50 crore)					(21780.36)

Particulars	2019	2020	2021	2022	2023
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 (Rs.)
Outflows:	
01-01-2019	(50,00,00,000)
Inflows:	
31-12-2023	66,03,29,644

Using the IRR formula:

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

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

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.

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 Worst-case Scenario:

(Rs. 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)		(9735)	(9558)	(10443)	(11505)	(12390.000)

Particulars	Jan 01 2019	Dec 31, 2019	Dec 31, 2020	Dec 31, 2021	Dec 31, 2022	Dec 31, 2023
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 by the Category III AIF, 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 Category III AIF 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.

The IRR metric is to be reported to SEBI on a quarterly or monthly basis by a Category III AIF. Consolidated IRR is also reported to SEBI, which is calculated by aggregating the cash inflows and cash outflows of all the Category III AIFs, managed by the Investment Manager.

6.2.1.2 Multiples Method

Performance of Category III 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 a Category III AIF, investors are more concerned with the amount of actual investment return "distributed" by the fund. If a Category III AIF 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. In case of open-ended Category III AIFs, Distribution of capital by the Fund is the most important parameter for judging the performance of the fund. The Investment Manager of a Category III AIF, 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.

In order to compare the distributions made by a Category III AIF, across multiple funds with comparable fund-term, the following concepts are taken into consideration:

- **Distributions to Paid-in Capital (DPI):**

DPI is the ratio between the total distributions made by the fund and the total capital contributions made by the investors. DPI measures the total amount distributed by the fund, per rupee of investment.

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

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.

- **Residual Value to Paid-in Capital (RVPI):**

RVPI is the ratio between the unrealized value of investments made by the fund and the total capital contributions made by the investors. The unrealized value of investments shall be distributed to the investors in the coming years. 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 unrealized investments represent the residual value of the fund after distribution, in other words, the Assets under Management of the Fund.

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

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.

- **Total Value to Paid-in Capital (TVPI):**

TVPI measures the Total Value generated by the fund, till the reporting date. Total Value represents the total of distributions plus the unrealized value of investments in the fund. TVPI is the ratio between the Total Value generated by the fund and the total capital contributions made by the investors.

$$\text{TVPI} = \frac{\text{Distributions} + \text{Assets under Management}}{\text{Total Capital Contributions}}$$

Alternatively, TVPI can be represented as summation of RVPI and DPI, i.e.,

TVPI = RVPI + DPI

Investors will always prefer a high TVPI, as it measures the Total Value generated, whether by distributions made or the value of unrealized assets in the fund.

For understanding TVPI, DPI and RVPI, let us continue with the example of Category III AIF – Fund ABC:

Example 7: DPI, RVPI and TVPI:

Category III AIF - Fund ABC is launched on January 01, 2019. Following are the details:

The Fund follows a Buy-and-Hold strategy. As per this strategy, all the assets of the fund are reinvested in the next year and net assets of the fund are distributed, at liquidation.

Same 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.

Committed Capital	Rs. 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 (Rs.)**	**Worst-case Scenario (Rs.)**
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 (Rs.)**	**2020 (Rs.)**	**2021 (Rs.)**	**2022 (Rs.)**	**2023 (Rs.)**
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	
DPI [D = B/A]	-	-	-	-	2.03
RVPI [E = C/A]	1.13	1.27	1.50	1.76	-

Particulars	2019 (Rs.)	2020 (Rs.)	2021 (Rs.)	2022 (Rs.)	2023 (Rs.)
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 (Rs.)	2020 (Rs.)	2021 (Rs.)	2022 (Rs.)	2023 (Rs.)
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.

6.2.2 Types of Risks

A Category III AIF is subject to the following types of risks:

1. **Market Risk**

Financial markets are volatile, exhibiting wide swings in market prices. In many instances, market prices defy rational analysis of Investment Managers and are influenced by movements of large funds as a result of short-term factors, counter-speculative measures or other reasons. Market volatility of large enough magnitude can weaken the fundamental basis for investing in any type of security. Investment expectations may therefore fail to be realised in such instances.

2. **Performance Risk**

Risks associated with the investment structure adopted by the Category III 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 Category III AIF, the Investment Manager may change the allocation of assets within the fund with greater risks. An investment in a Category III AIF entails a high degree of uncertainty and risk.

- **Dependence on Investment Manager**

Investors subscribing to units of a Category III AIF have no right to participate in the management of the fund. 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 have to be dissolved. 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 Category III AIF, in order to earn higher Incentive Fees.

- **Liquidity and Realisation of Investment**

Category III 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.

- **Concentration Risk**

Although the Investment Managers of Category III 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 restricted the maximum exposure of a Category III AIF to one security, which is up to a limit of 10 percent of investable funds in an Investee Company directly or through investment in units of other Alternative Investment Funds. However, large value funds for accredited investors of Category III AIFs may invest up to twenty percent of the investable funds in an 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 Category III AIF is not guaranteed by the Investment Manager, at regular intervals. If the Category III 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**

A Category III AIF may invest in assets through joint ventures or other co-investment structures with other parties. Such investments may have joint and several liabilities for the fund or a higher liability in comparison with the Fund's pro rata investment in the deal. Accordingly, the Fund may as a result of an act or omission of a third party investor suffer a loss higher than the Fund's pro rata share in the relevant investment.

- **Geo-Political Risks**

Uncertainties arising from war, recent world 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 Category III AIF's portfolio may be adversely affected by declines in the securities markets and economic activities 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.

3. Counterparty Risk

A Category III AIF transacts most of the investments through financial institutions including, but not limited to, brokers, dealers, banks, NBFCS, and distributors. All transactions will carry counterparty risks until the transactions have settled. All deposits of securities or cash with a custodian, bank or financial institution will carry counterparty risk. Upon default by counterparty, the Fund may be forced to unwind certain transactions and the Fund may encounter delays and difficulties with respect to court procedures in seeking recovery of the Fund's assets.

4. Funding Risk

Capital commitments are made by investors to the Category III 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.

5. **Interest Rate Risk**

Changes in interest rates may adversely affect the investments made by the Category III AIF and the income earned thereon, by affecting the spread between interest income and expenditure.

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 Category III 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.

6. **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.

7. **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.

A Category III 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.

8. **Cyber Security Risk**

As part of business, a Category III 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, 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, unauthorized release of confidential information and causing operational disruption.
A Category III AIF 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. On-line services provided by the Fund, or any of their service providers may also be susceptible to compromise.

9. Country-specific Risks

A Category III AIF 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.

10. Legal and Regulatory Risks

Regulatory reforms in the Alternative Investments Market by Securities Exchange Board of India (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 Category III AIFs, in India or outside India.

Legal and Regulatory Risk covers the following risk factors:

- **Regulatory Approvals**

Certain Indian regulatory approvals, including those of SEBI, the central government and the tax authorities, are required before the Category III AIF can make investments in Indian portfolio companies. 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. 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. There has been uncertainty in the Tax laws and Tax structures for Category III AIFs, which impacts the tax liabilities and net returns of the investors. 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.

11. Reputational Risk

If the Investment Manager of a Category III 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.

12. Leverage Risk

Investment Manager of a Category III AIF is permitted to take leverage, as per the prudential norms set-forth by SEBI which is currently two times the NAV of the fund. Investment Managers should not take excess leverage, which increases the inherent risk of the fund's investments, on account of positions in derivative contracts. Adequate internal controls should be implemented at the fund level to ensure compliance with the prudential norms and reporting any breach of leverage limits specified by SEBI, on a monthly basis if the fund is taking leverage.

13. Environmental, Social and Governance (ESG) Risk

All Alternative Investment Funds shall mandatorily follow a Stewardship Code in relation to their investment in listed equities.[124] The Investment Manager of a Category III AIF should ensure that they have adequate internal controls, processes and systems to ensure that the fund can successfully follow the Stewardship Code, from Financial Year 2020-21 onwards. 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.

6.2.3 Risk Metrics

Risk Factors disclosed in the Private Placement Memorandum (PPM) of a Category III AIF are discussed above. Investors should ascertain the inherent risk of the Fund, by analysing past

[124] 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.

performance of the fund or the manager. However, certain risks are not measurable, such as macro-economic risk, legal and regulatory risk, operational risk, country-specific risk and cyber security risks. Some of the common risk measures used to analyse the inherent risk of a Category III AIF are as under:

6.2.3.1 Standard Deviation

Standard Deviation is one of the most common measures used to measure historical risk of the fund, using the historical returns. Standard Deviation measures the volatility of return measures, from the mean return. Since volatility of the historical returns is measured in Standard Deviation, it is used to ascertain the historical risk of the fund.

Standard Deviation = σ = $\sqrt{\frac{\sum\left(R_i - \bar{R}\right)^2}{n}}$

where:
R_i – Return achieved in year i
$\bar{R}$ – Mean Return of the Fund (see Box 6.1)
n – Total number of years taken into consideration
i – Every Year for which the return is achieved

In present day, risk measures such as Standard Deviation can be easily computed using computer software, financial calculators and online websites.

Box 6.1: Mean

Mean is the average of the historical returns of the fund. Investors will prefer a higher Mean of the historical returns, which signifies increased returns generated by the fund historically. Mathematically, mean is represented as:

$$\text{Mean } (\bar{R}) = \frac{\sum \boldsymbol{R}_i}{n}$$

Where,
R_i – Return achieved in year i
n – Total number of years taken into consideration
i – Every Year for which the return is achieved

Let us understand the calculation of Standard Deviation with the help of an example:

Example 8: Calculation of Mean and Standard Deviation:

The following table shows the historical returns earned by two Category III AIFs:

Particulars	Year 1	Year 2	Year 3	Year 4	Year 5
Fund A	12.50%	11.25%	13.65%	17.30%	14.65%
Fund B	21.50%	-0.50%	16.75%	20.25%	21.90%

Calculate the Mean and Standard Deviation for the Fund.
Answer:

$$\text{Mean (Fund A)} = \frac{12.50 + 11.25 + 13.65 + 17.30 + 14.65}{5} = \mathbf{13.87\%}$$

$$\text{Mean (Fund B)} = \frac{21.50 - 0.50 + 16.75 + 20.25 + 21.90}{5} = \mathbf{15.98\%}$$

Standard Deviation is computed taking Mean as computed above:

$$\text{Fund A } \boldsymbol{\sigma} = \frac{\sqrt{(12.50-13.87)^2 + (11.25-13.87)^2 + (13.65-13.87)^2 + (17.30-13.87)^2 + (14.65-13.87)^2}}{5}$$

Fund A σ = 2.06%

$$\text{Fund B } \boldsymbol{\sigma} = \frac{\sqrt{(21.50-15.98)^2 + (-0.50-15.98)^2 + (16.75-15.98)^2 + (20.25-15.98)^2 + (21.90-15.98)^2}}{5}$$

Fund Bσ = 8.44%

From the above risk measures, we can infer that Fund A has generated low returns, as compared to Fund B. However, the inherent risk of Fund B is much higher as compared to the inherent risk of Fund A. Hence, a prudent investor will choose Fund A over Fund B.

6.2.3.2 Skewness and Kurtosis

Skewness and Kurtosis are two important risk measures for a Category III AIF. In order to understand and analyse these risk measures it is important to know the concept of normal distribution, though Category III AIFs do not necessarily follow a normal distribution.

Normal Distribution:

The normal distribution, or the "bell-shaped" curve, is commonly applied for statistical analysis of data and interpreting the inherent risk of a security. A normal distribution is perfectly symmetrical when divided in two halves by the mean of the data interpreted. The frequency of each observation in the data set is shown in the curve, across the mean. The values above the mean appear on the right-hand side of the mean and the curve. Similarly, values below the mean or negative vales appear on the left-hand side of the mean. The values are distributed based on how many standard deviations (σ) away is the value, from the mean.

Let us understand the concept of normal distribution through an example.

Example 9: Normal Distribution:

The following table shows the mean and standard deviation of 5-year return of two Category III AIFs:

Particulars	Mean	Standard Deviation
Fund A	13.87%	2.06%
Fund B	15.98%	8.44%

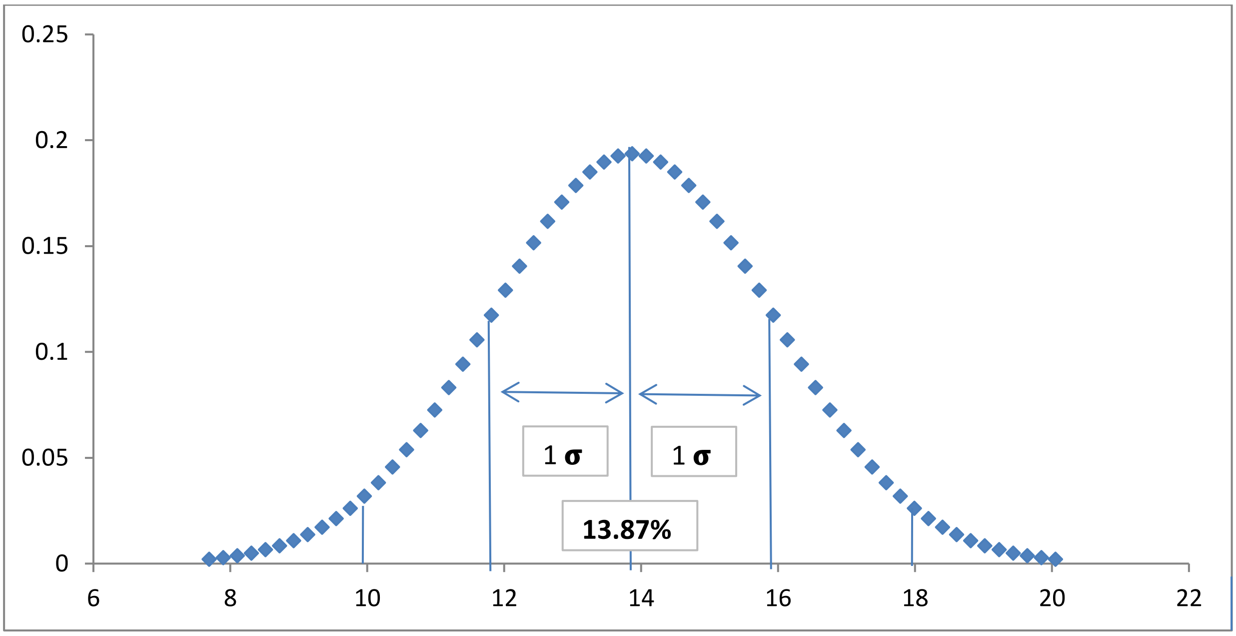
The following table shows the historical returns earned by two Category III AIFs:

Particulars	Year 1	Year 2	Year 3	Year 4	Year 5
Fund A	12.50%	11.25%	13.65%	17.30%	14.65%
Fund B	21.50%	-0.50%	16.75%	20.25%	21.90%

Analyse the data using a Normal Distribution.

Solution:
The data set of the historical returns can be plotted on the Normal Distribution to interpret the inherent risks.

Exhibit 1: Normal Distribution – Fund A



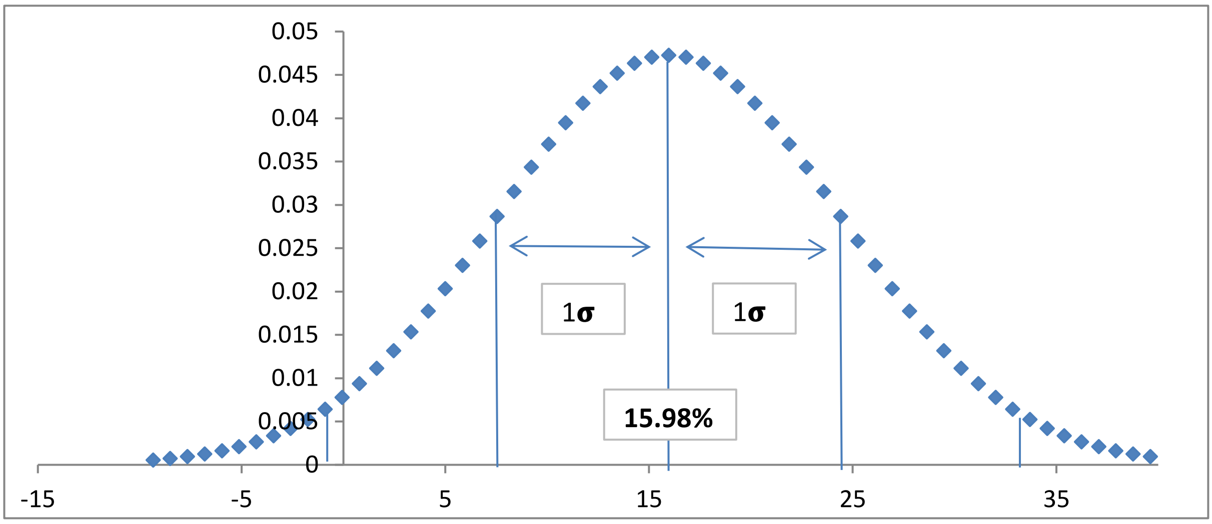
As seen from the exhibit, the Mean of Fund A, which is 13.87%, is the centre line of the Normal Distribution, with 50% of the return values on the left of the mean and 50% of the return values on the right of the mean.

The Normal Distribution shown in Exhibit 1 is constructed by taking increments of 3 σ of the value of returns, towards the left and right side of the mean.

Mean +/- 1 σ represent 68% of the total returns being observed
Mean +/- 2 σ represent 95% of the total returns being observed

It can be observed from the table, that three out of five returns are in the range of 1 **σ** towards the right of the mean plus 1 **σ** towards the left of the mean.

Exhibit 2: Normal Distribution – Fund B



As seen from the exhibit, the Mean of Fund B, which is 15.98%, is the centre line of the Normal Distribution, with 50% of the return values on the left of the mean and 50% of the return values on the right of the mean. The Normal Distribution shown in Exhibit 2 is constructed by taking increments of 3 σ of the value of returns, towards the left and right side of the mean.

In Year 2, the fund had generated a negative return of -0.50%. Due to this return, the normal distribution curve moves beyond the y-axis, to represent the negative return as an outlier.

Outliers are extreme returns, whether highly positive or highly negative returns. Prudent investors would never prefer historical performance of a fund to exhibit outliers, as it signifies increased market risk and a volatile fund strategy.

To interpret the effect of outliers, risk measures of Skewness and Kurtosis are important.

Skewness

As discussed above, the normal distribution is the distribution of the frequency of each data point appearing within the curve. Mode is the highest frequency of any data point. Hence, the point where the curve is at its peak is the Mode for that Distribution. In a Normal Distribution, the Mode and the Mean are at the same point, where the distribution is peaked.

Skewness, or skew, refers to the extent to which a distribution is not symmetrical across the mean. Skewness is a result of outliers, either above or below the mean. Although, outliers above the mean are sometimes beneficial, investors must be diligent of the outliers lying below the mean. For this purpose, we calculate the Skewness of a distribution and compare the skewness value to that of a Normal Distribution. Since a Normal Distribution is perfectly symmetrical, it has a **Skewness of Zero.**

A **positively skewed distribution** is skewed right, due to large outliers on the positive side and above the mean. Due to positive outliers, the distribution may have a relatively long right tail, as compared to the normal distribution.

In a positively skewed distribution, the mean shifts away from the mode, as a new positive outlier (return) is added to the set of returns. If a high return is added to the data set, the mean is set to increase. Hence, the Mean is always higher than the Mode, in a positively skewed distribution.

A **negatively skewed distribution** is skewed left, due to large outliers below the mean or on the negative side. Due to negative outliers, the distribution may have a relatively long left tail, as compared to the normal distribution. In a negatively skewed distribution, the mean shifts below the mode, as a new outlier is added which is below the mean. Hence, the Mean is always lesser than the Mode, in a negatively skewed distribution.

A distribution having Skewness of greater than zero indicates a positively skewed distribution and a distribution having Skewness of less than zero indicates a negatively skewed distribution. Skewness, in itself, is an important risk measure to check the extent of outliers in the returns of the fund. While the investors will not prefer the distribution of returns to be skewed, Positive Skewness is preferred over Negative Skewness.

Let us understand Skewness, by continuing the example of Fund A and Fund B:

Example 9.1: Skewness:

Returns of Year 6 are added to the historical performance of Fund A and Fund B:

Particulars	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6
Fund A	12.50%	11.25%	13.65%	17.30%	14.65%	13.85%
Fund B	21.50%	-0.50%	16.75%	20.25%	21.90%	20.80%

Particulars	Mean	Standard Deviation
Fund A	13.87%	1.88%
Fund B	16.78%	7.91%

Calculate the Skewness of Fund A and Fund B and interpret the results.

Solution:

Skewness can be calculated in Microsoft Excel, using the “Skew” Function, as under:

=SKEW(range)

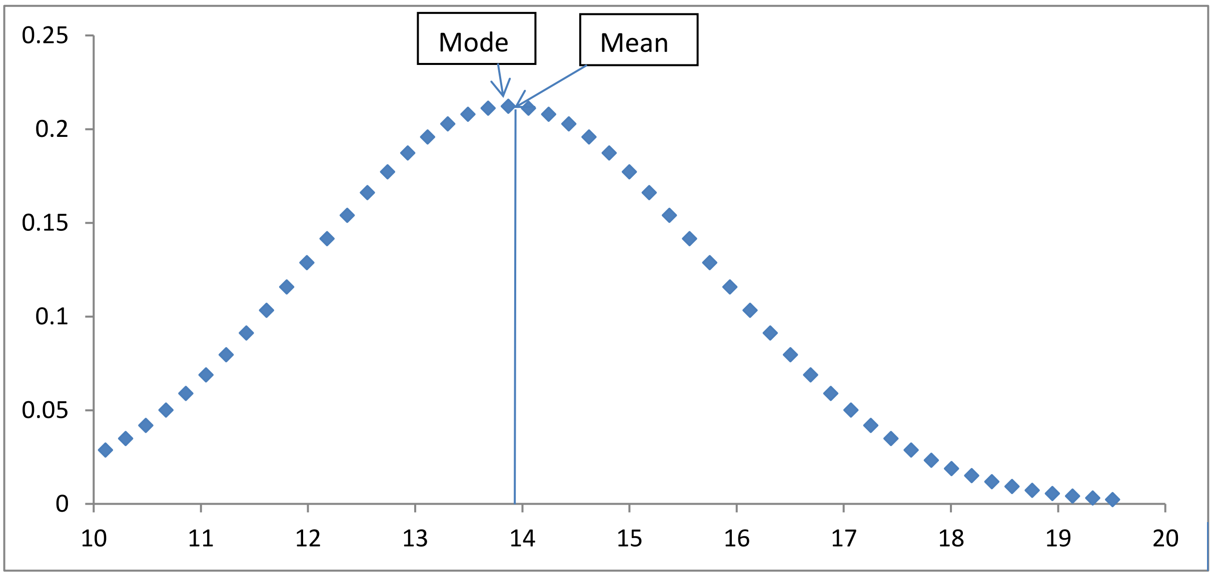
where range is the range of returns earned by a fund, over any number of periods.

Calculating Skewness of returns for the funds, we get the following data:

Particulars	Mean	Standard Deviation	Skewness
Net Returns - Fund A	13.87%	1.88%	0.705
Net Returns - Fund B	16.78%	7.91%	-2.222

As seen from the above data, Fund A exhibits Positive Skewness and Fund B exhibits Negative Skewness. On comparison of risk based on Skewness, Fund B is riskier than Fund A. This is also summarized in the following exhibits:

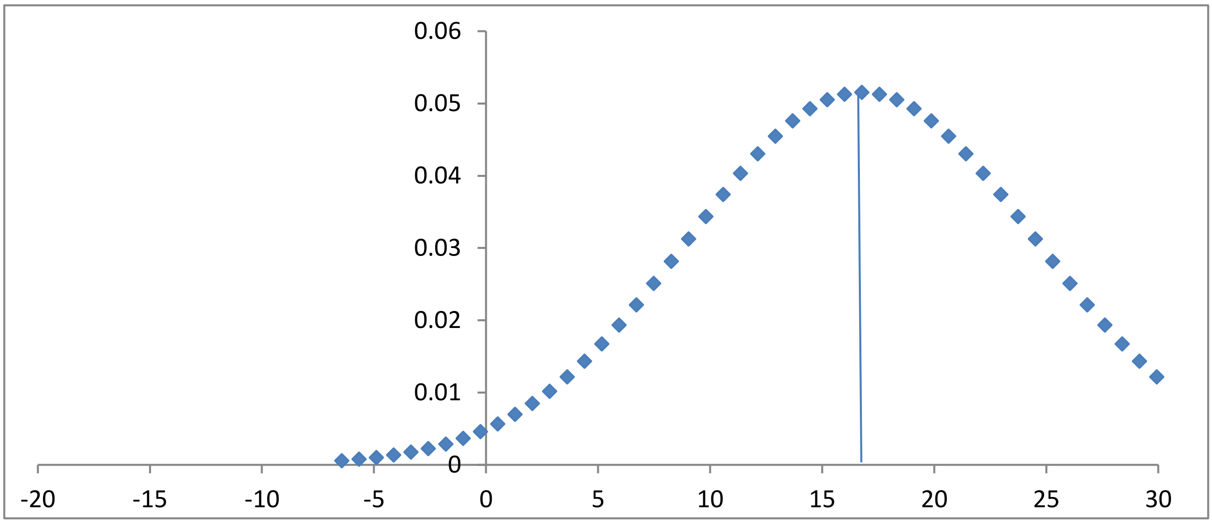
Exhibit 3: Positive Skewness – Fund A



As seen from Exhibit 3, the returns of Fund A exhibit Positive Skewness. The distribution is asymmetrical due to positive outliers and more values in the right tail. Due to positive outliers, the Mean is greater than the Mode of the Distribution.

Since the value of the positive outliers is not significantly higher than the mean, the Fund is not a risky investment, as compared to Fund B.

Exhibit 4: Negative Skewness – Fund B



As seen from Exhibit 4, the returns of Fund B exhibit Negative Skewness. The distribution is asymmetrical due to negative outliers and more values in the left tail. Since the Fund has negative outliers as well as positive outliers, it is possible that the Mean is not significantly different from the Mode of the Distribution. However, due to Negative Skewness, Fund B is a risky investment, as compared to Fund A.

Kurtosis

Kurtosis refers to the degree to which a distribution is more or less "peaked" than a normal distribution. If a distribution is peaked, it indicates the presence of outliers with large deviations from the mean. Kurtosis is calculated to check the level of "peakedness" of the distribution. A Normal Distribution has a **Kurtosis of Three.** Therefore, a distribution with a Kurtosis above 3 is considered riskier, in its comparison with the normal distribution, as it represents an Excess Kurtosis greater than zero (excess of kurtosis value over 3).

Leptokurtic Distributions have a Kurtosis higher than 3, or Excess Kurtosis greater than zero. Such distributions have data values which are either around the mean or substantially deviating away from the Mean.

Platykurtic Distributions have a Kurtosis below 3, or Excess Kurtosis less than zero. Such distributions have data values with consistent frequencies around the mean and no significant deviations.

Kurtosis measures the level of deviations of data values, from its means. Distributions having fatter tails and higher peaks will have a high kurtosis. Investors must be diligent about funds exhibiting return distributions with fatter tails, as it is an indicator of inconsistent performance.

Let us understand Kurtosis, by continuing the example of Fund A and Fund B:

Example 9.2: Kurtosis:

Returns of Fund A and Fund B are as under:

Particulars	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6
Fund A	12.50%	11.25%	13.65%	17.30%	14.65%	13.85%
Fund B	21.50%	-0.50%	16.75%	20.25%	21.90%	20.80%

Particulars	Mean	Standard Deviation
Fund A	13.87%	1.88%
Fund B	16.78%	7.91%

Calculate the Kurtosis of Fund A and Fund B and interpret the results.

Solution:

Kurtosis can be calculated in Microsoft Excel, using the "Kurt" Function as under:

=KURT(range)

where range is the range of returns earned by a fund, over any number of periods.

Calculating Kurtosis of returns for the funds, we get the following data:

Particulars	Mean	Standard Deviation	Skewness	Kurtosis
Fund A	13.87%	1.88%	0.705	1.162
Fund B	16.78%	7.91%	-2.222	5.034

As seen from the above data, Fund A exhibits Negative excess Kurtosis and Fund B exhibits Positive excess Kurtosis, as follows:

Fund A: 1.162 – 3.000 = **-1.838**

Fund B: 5.034 – 3.000 = **2.034**

On comparison of risk based on Kurtosis, Fund B is riskier compared to Fund A.

Conclusion:

On analyzing the Fund Performance and Risk Measures of Fund A and Fund B, it is observed that risk measures such as Standard Deviation, Skewness and Kurtosis have concluded that Fund B is riskier than Fund A. However, it is important for sophisticated investors to not analyze all the risk measures in isolation.

On independent analysis of Mean and Standard Deviation of Fund A and Fund B, an investor having a high risk appetite may still invest in Fund B, after analyzing the mean and standard deviation. However, without analyzing the Skewness and Kurtosis of the Funds, such investor would ignore the probability of outliers and volatility of expected returns of the funds. Increased analysis of risk measures can significantly influence investment decisions of investors, especially in illiquid assets such as Category III AIFs.

6.2.4 Risk-adjusted Return Metrics and Performance Measures

Risk-adjusted performance measures allow investors to compare the returns of a Category III AIF, adjusted for the risk level of a benchmark. The following measures can be useful for investors to compare the performance of a Category III AIF with its peers and for investment managers to summarize the risk and return characteristics of the fund.

6.2.4.1 Sharpe Ratio

The Sharpe ratio calculates how the Category III AIF compensates an investor for the risk they've taken by investing in the fund. The Sharpe Ratio computes the excess return earned by the fund over the risk-free rate, per unit of total risk taken as defined by its portfolio standard deviation. The returns from a risk-free security such as T-bills or Government Securities are commonly used as the risk-free rate, for the purpose of computing the Sharpe Ratio.

When comparing two different investments against the same benchmark, the asset with the higher Sharpe ratio provides a higher return for the same amount of risk or the same return for a lower risk than the other asset. Sharpe ratios greater than 1 are preferable. Investors prefer a higher Sharpe ratio for a better risk-adjusted return from the fund.

Sharpe Ratio= $\frac{R_p - R_f}{\sigma_p}$

where:

R_p = Expected Portfolio Return

R_f = Risk-free Return

σ_p = Portfolio Standard Deviation

6.2.4.2 Treynor Ratio

The Treynor ratio computes the excess return earned by the fund over the risk-free rate, per unit of the Systematic risk taken by the fund, as defined by its portfolio Beta, which is not diversifiable.

If the ratio shows a high value, it means the investment offers a relatively high return with the inclusion of market risks. The Treynor ratio is based on the premise that the risk premium generated by an investment manager of a Category III AIF should not be compared with the total risk, but with the risk which is not diversifiable.

Treynor Ratio= $\frac{R_p - R_f}{\beta}$

where:
R_p = Expected Portfolio Return
R_f = Risk-free Return
β = Portfolio Beta

For performance measurement of well-diversified portfolios, the Treynor Ratio and Sharpe Ratio may provide identical results as the total risk may be similar to the systematic risk of the portfolio. However, for undiversified portfolios, the results are likely to differ. Therefore, on comparison of undiversified portfolios, investors should prefer to use the Sharpe Ratio over Treynor Ratio.

Example 10:

The following table shows the performance data for the 5 funds managed by Investment Manager PQC:

Particulars	Growth	Diversified	Long-only	Long-short	Directional
Expected Returns (R_p)	24.50%	13.25%	15.75%	19.30%	14.65%
Standard Deviation (σ_p)	3.35%	1.05%	2.15%	2.26%	1.96%
Beta (β)	3.50	1.01	1.82	1.95	1.73
364-day T-bill rate (R_f)	5.60 %				

Calculate the Sharpe Ratio and Treynor Ratio for the funds. Analyse the results.

Solution:

Particulars	Growth	Diversified	Long-only	Long-short	Directional
Sharpe Ratio **[(R_p - R_f)/σ_p]**	5.64	7.29	4.72	6.06	4.62

Treynor Ratio **[(R_p - R_f)/β]**	5.40	7.57	5.58	7.03	5.23

Conclusion:

- For the Diversified Portfolio, it is observed that the Sharpe Ratio and the Treynor Ratio results are almost identical, as the Beta is almost equal to the total risk of the fund, i.e. the standard deviation.

- Analysis of Sharpe Ratio and Treynor Ratio provides further analysis for an investor in the funds. On comparison of the performance of the Growth fund and the Long-short fund, returns of the Growth fund are higher, however, the Sharpe Ratio and the Treynor Ratio are high for the Long-short fund on account of the lower risk.

6.2.4.3 Maximum Drawdown

Maximum drawdown (MDD) is the peak-to-trough decline in the Assets under Management (AUM) of a Category III AIF, during a specific reporting period. It is usually quoted as a percentage of the peak value, or the highest AUM, achieved by the fund in the reporting period.

MDD = $\frac{\textbf{(Trough Value—Peak Value)}}{\textbf{Peak Value}}$

Maximum drawdown measures the extent of the greatest loss in a portfolio, until a new peak value is created. However, it does not take into consideration how often the portfolio experiences large losses and it does not indicate the length of time it shall take an investor to be able to recover the loss.

It is important to use Maximum Drawdown with the right perspective. Although investors would prefer a zero value of the maximum drawdown, it is important to pay attention to the time period being considered in the reporting period and the performance of a benchmark over the same time period.

Example 11:

The following table shows the performance data for the Fund PQR and NIFTY50 for the quarter ending March 31, 2020:

Particulars	**January 01, 2020**	**January 15, 2020**	**February 01, 2020**	**February 14, 2020**	**March 01, 2020**	**March 23, 2020**	**March 31, 2020**
FUND PQR (AUM in Rs. crore)	560.45	585.96	584.23	632.33	596.29	564.35	545.61
NIFTY50	12202.15	12430.50	11661.85	12113.45	11132.75	7610.25	8597.75

(Index Value)							

Compute the Maximum Drawdown for Fund PQR. Analyse the results, assuming NIFTY50 is an appropriate benchmark for Fund PQR.

Solution:

Particulars	**Fund PQR (Rs. crore)**	**NIFTY50**
Trough Value	545.61	7610.25
Peak Value	632.33	12430.50
Maximum Drawdown [(**Trough Value–Peak Value)/Peak Value]**	-13.71%	-38.78%

Conclusion:

- Although the Maximum Drawdown for Fund PQR is high at -13.71%, it is much lower than Maximum Drawdown for its benchmark, NIFTY50, which is -38.78%.
- This shows that even when capital markets were facing the downside risk[125], due to external factors, the downside risk for Fund PQR was lower than the downside risk for the overall market.

6.2.4.4 Value at Risk

Value at Risk (VaR) is a measure used to quantify the downside risk in a Category III AIF. VaR is defined as the maximum amount of expected loss for a fund, over a given time frame and a pre-defined confidence level.

For example, if the 95% one-month VAR of Fund XYZ is Rs. 1 crore, there is 95% probability that over the next month, the fund will not lose more than Rs. 1 crore. Conversely, it can be said that there is a 95% probability that the maximum loss for Fund XYZ, over the next month, will be up to Rs. 1 crore.

VaR modelling helps to determine the potential for loss and the probability of occurrence of such loss over a defined timeframe. Investors would prefer a VaR to be close to zero for any Category III AIF. However, given the inherent market risks faced by every Category III AIF, investors should choose to invest in the fund with lowest VaR over a defined time period.

VAR has a number of limitations. While quantifying the maximum potential loss, it fails to indicate the size of the loss to be borne by the fund, upon a certain event and based on a defined confidence level.

[125] Downside Risk is the probability of a loss on account of reducing asset prices in changing market conditions.

6.3 Performance Benchmarking

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

Benchmark is the comparable fund or index having similar risk return characteristics as the Category III AIF being monitored. Benchmark Return is the return generated by the chosen benchmark, over the reporting period.

A Category III 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 Category III 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 III AIF, 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 invests. 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 a Category III AIF.

Some Category III 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. Returns for the fund are then computed every year, using the risk-return measures discussed in this chapter. 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.

Example 12: Benchmarking:

Following are extracts provided from the PPM of three funds, Fund X, Fund Y and Fund Z. Interpret the investment strategy and suggest a suitable benchmark for the Funds, with a rationale.

Particulars	**Fund X**	**Fund Y**	**Fund Z**
Investment Strategy	Equity Long-only	Market-Neutral	Long-only
Fund Tenure	3 years	5 years	7 years
Type of Securities	Listed Equities	Unlisted Equities and Listed Equities	Listed Equities, Listed SMEs and Unlisted SMEs
Market-cap of Target Companies	Large-cap Companies	Mid-cap Companies	Small-cap Companies and SMEs
Target Allocation	100% - Listed Equities	80% - Listed Equities 20% - Unlisted Equities	50% - Listed Equities 25% - Listed SMEs 25% - Unlisted SMEs
Target Sectors	Sector-agnostic	20% - Unlisted BFSI 20% - Listed FMCG 20% - Listed Pharma 10% - Listed Realty 10% - Listed Metal 20% - Listed IT	Sector-agnostic
Leverage	Index Options	No Leverage	No Leverage

Solution:

Fund X: AIF X is investing primarily in Large-cap listed companies. Hence, the appropriate benchmark can be either of the following:

- NIFTY 50
- S&P BSE SENSEX
- NIFTY Next 50
- S&P BSE Next 50
- NIFTY 100
- S&P BSE 100

Investors can choose the appropriate benchmark, based on actual investments made and the market-cap of the securities. If the Fund is investing in blue-chip stocks only, then NIFTY 50 or S&P BSE SENSEX can be used.

Fund Y: AIF Y is making thematic investments and investing in listed as well as unlisted securities. On careful observation, it is observed that the entire 20% allocation of unlisted equity shares is towards BFSI sector, while 80% allocation of listed equity shares is across sectors. In such a scenario, the benchmark can be constructed using the actual weights, similar to the targeted allocation. This can be done as follows:

Investment Allocation	Portfolio Weight	Recommended Benchmark
Banking and Financial Services	20%	NIFTY FINANCIAL SERVICES / NIFTY BANK / S&P BSE Finance / S&P BSE BANKEX
Fast Moving Consumer Goods	20%	NIFTY FMCG / S&P BSE Fast Moving Consumer Goods
Pharmaceuticals	20%	NIFTY PHARMA / S&P BSE Healthcare
Metals and Mining	10%	NIFTY METAL / S&P BSE Metal
Realty	10%	NIFTY REALTY / S&P BSE Realty
Information Technology	20%	NIFTY IT / S&P BSE Information Technology

Alternatively, the benchmark can be based on the targeted sector, i.e. Mid-cap. Following indices may be used as benchmarks:

- NIFTY Midcap 100
- NIFTY MidCap50
- NIFTY Midcap 150
- S&P BSE Midcap
- S&P BSE 150 Midcap
- S&P BSE 250 Midcap
- S&P BSE Midcap Select

In order to get a comprehensive performance comparison, a weighted benchmark can also be created, by considering the results from both type of benchmarks used and assigning a weightage to each type of benchmark. One of the recommended ways can be as under:

Benchmark Used	Benchmark Weight (recommended)
Sectoral Benchmarks	75%
Mid-cap Benchmark	25%
Fund Y Benchmark	**100%**

Fund Z: AIF Z is investing in equity shares of SMEs as well as small-cap listed companies. Hence the benchmark can be constructed in the following manner:

Investment Allocation	Portfolio Weight	Recommended Benchmark
Small-cap Listed Equity Shares	50%	• NIFTY SMALL CAP 100 • NIFTY SMALL CAP 50 • NIFTY SMALL CAP 250 • S&P BSE Small Cap • S&P 250 BSE Small Cap

		• S&P BSE Small Cap Select
Listed and Unlisted SMEs	50%	• NIFTY SME • S&P 250 SME Index

The above indices and benchmarks are recommended benchmarks. Every Investment Manager and the investors should individually decide the most appropriate benchmark, as per the investment strategy of the fund.

Benchmarking Agencies:

As discussed above, performance benchmarking for Category III 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 Category III AIF industry as a whole, to compare the performance of every Category III AIF, 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.[126] 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. The form and format of reporting shall be mutually decided by the Association and the Benchmarking Agencies.

A Category III 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 Category III 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 Category III 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. Category III AIFs would be required to disclose the benchmarked performance, as derived by the Benchmarking Agency, in all marketing materials and investor reports. This will enable investors to access performance data of Category III AIFs, with accurate benchmarking.

SEBI has also laid down detailed operational guidelines for implementation of performance benchmarking (see Box 6.2).

[126] SEBI 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).

Box 6.2: 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, within 45 days from the end of every half-year ending on 30th September and within 6 months from the end of every half-year ending on 31st March. 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 September30 may be unaudited data.
(f) Valuation of investments shall be in the manner provided in the specific Scheme's PPM or fund documents, as the case may be. Any change to valuation principle shall be informed to the Benchmarking Agencies in the immediate next data submission.
(g) Assets under Management (AUM) for the purpose of reporting and benchmarking shall be the value of total capital drawn down under the Scheme.
(h) The performance reporting and benchmarking shall be carried out on pre-tax Net Asset Value (NAV) of the Scheme.
(i) 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.
(j) 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.
(k) Benchmarking Agencies shall provide a Performance Benchmark Report to the individual AIFs/ Schemes vis-à-vis the industry benchmarks.
(l) 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.
(m) The performance data and benchmarks shall be reported in both INR and USD terms.

Section B:

(n) 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.

To ensure timely and appropriate reporting of valuation of investment portfolio to performance benchmarking agencies, the following is specified:[127]

- The Investment Manager shall ensure that a specific timeframe for providing audited accounts by an investee company is included as one of the terms in subscription agreement / investment agreement with such investee company. This enables the Category III AIF to report valuation based on audited data of investee companies, as on March 31 of every financial year, to performance benchmarking agencies within the specified timeline of 6 months.
- The Investment Manager shall ensure that valuation, based on audited data of investee companies, is reported to performance benchmarking agencies only after the audit of books of accounts of the Category III AIF, within the stipulated timelines as provided in the SEBI (Alternative Investment Funds) Regulations.

The first performance benchmark indices for all categories of AIFs are launched on October 1, 2020 by CRISIL Research, a rating agency appointed by Indian Private Equity and Venture Capital Association (IVCA). Subsequently, considering the rising importance of AIF as an asset class, 2 additional performance benchmark indices were launched by NSE Indices Ltd. and Prequin.[128]

6.3.1 Role of a benchmark in evaluating alpha generated by a Category III AIF

Alpha (α) is the excess return generated by a Category III 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). The Capital Asset Pricing Model compares the return achieved by the fund to the **"Expected Return".**

Expected Return is calculated in a unique manner, using CAPM. Ideally, the Expected Return

[127] SEBI Circular No. SEBI/HO/AFD/PoD/CIR/2023/97 dated June 21, 2023, on Standardised approach to valuation of investment portfolio of AIFs, effective on November 1, 2023.
[128] https://www.ivca.in/resources/performance-aifs

from an investment is a return above the Opportunity Cost of that investment. However, under CAPM, the Expected Return is computed with the following three elements:

- **Risk-free Rate of Return (Rf)**: The expected return from a risk-free security such as T-bills or Government Securities.

- **Beta (β)**: The measure of volatility of the fund, with respect to the relevant benchmark. Beta is also known as Systematic Risk, such as changes in geo-political conditions, macro-economic conditions and other market forces which are not in control of the Investment Manager. Such risk is not diversifiable.

- **Market Risk Premium (Rm - Rf)**: The excess premium generated by the benchmark or the selected broad-based index, over the risk-free rate of return. If the premium is high, it is beneficial for the investor to invest in such category of investments, funds or broad-based indices. Rm represents the return generated by the benchmark.

Expected Return is computed using the CAPM, as under:

$$E(R) = R_f + \beta(R_m - R_f)$$

where:
$E(R)$ = Expected Return
R_f = Risk-free Return
β = Beta
R_m= Benchmark Return

Finally, Alpha is the difference between the Return achieved and Expected Return.

Alpha (α) = R – E(R)

The CAPM is based on important assumptions, as follows:

- **Risk and Return:** A riskier asset will yield a higher return. CAPM assumes that past performance is a good measure of future performance.

- **Risk-free Return:** Risk-free return will remain constant over the course of the investment. This may not be possible, as return on government securities may rise or fall.

- **Information-efficiency:** Investors have access to the same information and have the same decision-making process with respect to the risks and returns of the investment.

- **Taxes and Costs:** There are no taxes, transaction costs or any borrowing costs with respect to investment.

- **Risk-averse Investors:** CAPM assumes that the investors are risk-averse, to invest rationally. For a given return the investors will prefer low-risk securities over high-risk securities and for a given risk the investors will prefer higher returns to lower returns.

- **Decision-making:** Only returns and risks are the decision making factors for investors. Investors do not consider the long term growth or qualitative factors of an investment.

- **Perfect Competition:** There is perfect competition in the market and no single investor can influence the prices or the returns of the investment.

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

Example 11:

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
364-day T-bill rate	5.60 %	
BSE 100 return (2019)	9.25%	

Calculate and analyse the Alpha for Fund XYZ.

Solution:

Particulars	**Best-case Scenario**	**Worst-case Scenario**
Expected Return **[E(R) = R_f +β*(R_m - R_f)]**	5.60% + 1.30*(9.25% - 5.60%) = 10.35%	5.60% + 1.50*(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.

- BSE 100 is taken as the reference benchmark, on the assumption that the fund is investing in large-cap stocks.

- On observation, the time period for all risk and return measures are identical. Net IRR is calculated on a yearly basis. T-bill rate is for 364-day period. BSE 100 return is for one year – 2022.

- Beta has changed for Best-case scenario and Worst-case scenario, as the Investment Manager is taking additional systematic risk, due to macro-economic factors. 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.

Chapter 6: Sample Questions

1. **Which risk measure is used to ascertain the extent to which a distribution is not symmetrical across the mean?**

    a. Standard Deviation
    b. Mean
    c. **Skewness**
    d. Kurtosis

2. **Exit Load can be charged to investors in a Category III AIF but not to investors in a PMS. State whether True or False.**

    a. True
    b. **False**

3. **_________ is the highest Net Asset Value, net of all expenses and management fees, achieved by the Category III AIF at the end of the year.**

    a. **High Water Mark**
    b. Hurdle Rate
    c. Net Asset Value (Pre-tax)
    d. Gross NAV

4. **Which risk-adjusted measure is used to compare the Risk Premium per unit of Systematic Risk borne by the fund.**

    a. Sharpe Ratio
    b. **Treynor Ratio**
    c. Maximum Drawdown
    d. Value at Risk

5. **RVPI can be represented as summation of TVPI and DPI. State whether True or False.**

    a. True
    b. **False**

Chapter 7: Category III AIF Investment Strategies and Due Diligence Process

LEARNING OBJECTIVES:

After studying this chapter, you should know about:

- Various Investment Strategies
    - Equity market strategies (Long-only/ Long-short/ Market neutral/ Directional and Short basis)
    - Global macro Strategy
    - Convertible arbitrage strategy
    - Event-driven strategies (Activist/ Merger Arbitrage/ Pre-IPO)
- Due diligence process before investing in Category III AIFs

7.1 Equity-Market Investment Strategies

Category III AIFs have been primarily investing in Equities and Derivatives contracts, with Equities or Equity Indices as the underlying asset.

A Category III AIF is a pooled investment vehicle, which collects investment capital from investors to invest the funds over a long-term. Category III AIFs may take leverage, short positions and derivative positions, in order to generate absolute returns for investors over the medium and long term. Hence, these funds generally do not invest for the purpose of intra-day trading. Speculative investments in equities may be made, if the investment manager can predict short-term profit generation for the fund. The targeted sector for investment, basis for selection of investments, time horizon and risk-return profile of selected investments is clearly outlined by the investment manager, in the Investment Strategy of the Category III AIF. The Investment Strategy is also disclosed to the investors, in the Private Placement Memorandum of the fund. By making capital commitments to the fund, the investor indirectly provides consent to the investment manager on the stated investment strategy.

Equity-Market Investment Strategy followed by Category III AIFs is a diverse and complex strategy formulated by the Investment manager, stating the nature of positions to be taken in Equities or Derivatives contracts, with Equities or Equity Indices as the underlying asset. The Investment Strategy may be to invest by taking only long positions in Equities, or short positions in Equities, or a combination of both types of positions. Common types of Equity-Market Investment Strategies are explained below:

7.1.1 Long-only Equity Strategy

The Long-only Equity Strategy focuses on delivering absolute returns for investors over the medium to long-term, with a strong emphasis on capital preservation. In a Long-only Strategy, the Category III AIF manager would take a long position, or a 'buy' position in the selected stocks. The manager would generally not take a short position, or a 'sell' position in the selected stocks, at the time of investments in stocks. Investment managers make stock selection using a top-down or bottom-up fundamental approach, with an aim to invest in companies having predictable, scalable and quality business models. In order to invest in such companies, the investment manager would analyse historical data of the target companies of dividend pay-outs, return on capital employed and other important financial parameters.

However, in order to protect the fund against losses, a prudent investment manager may take a "hedging position" to minimize the market risk due to decrease in value of a stock. Hedging positions can be taken by taking opposite positions, i.e. a Sell position, in a Futures or Options contract of the stock or index under consideration. A sell position can be taken through a "Short" position in a Futures contract or by buying a "Put" option, with the underlying asset having similar characteristics as the reference asset in the portfolio. Despite hedging positions taken by an investment manager, a Long-only Strategy may be volatile and risky, during economic downturns. Let us understand the Long-only Strategy, using the following example.

Example 1: Long-only Strategy

Fund FGH is a Category III AIF, with a Long-only Investment Strategy. Investments are made in large-cap stocks and mid-cap stocks. Analyse the investments made by the fund.

Long Positions: As on April 01, 2020

Particulars	Quantity	Market Price (Rs.)	Total Value (Rs.)
Stocks: Large-cap			
Company A	1,00,000	320	3,20,00,000
Company B	10,00,000	50	5,00,00,000
Company C	3,00,000	250	7,50,00,000
Company D	4,00,000	500	20,00,00,000
Stocks: Mid-cap			
Company E	1,00,000	500	5,00,00,000
Company F	1,00,000	930	9,30,00,000

Analysis:

Fund FGH has taken Long Positions in Large-cap and Mid-cap stocks and invested Rs. 50 crore. On account of the unexpected volatility of the stock market, it is advisable that the investment manager takes a hedging position against any future downfall. Futures and Options in a broad-based market index such as NIFTY50 or S&P BSE SENSEX can partially hedge the inherent market risk of the Fund. Options can prove to be more efficient as compared to Futures, for the purpose of Hedging. The most suitable hedging strategy can be to Buy a Put Option on the NIFTY50 or S&P BSE SENSEX, or a combination of the indices, and keep rolling the option contracts forward. One example of a hedging position is given below:

Hedging Positions:

Particulars	Strike Price	Lot-size (Contracts)	Quantity (Lots)	Market Price (Rs.)	Total Exposure (Rs.)
Put Options Bought					
NIFTY50: Expiry – 31 Dec 20	9000.00	450	150	500.00	3,37,50,000

As seen from the table above, the Fund FGH can take Put options in NIFTY50, with an expiry of December 31, 2020, which is nine months from the date of holding securities. These contracts can be rolled forward to a future expiry date, based on the years for which the same investments will be held by the Fund FGH. The hedging positions, type of contracts and indices used should be changed on a regular basis, to replicate the characteristics of the investments in the fund portfolio.

7.1.2 Long-Short Equity Strategy

The Long-Short Equity Strategy focuses on delivering absolute returns, by identifying over-priced and under-priced stocks, relative to the investment manager's fair valuation. Fair valuation of target stocks is done using fundamental analysis and taking into account macro-economic factors, industry-specific factors and government reforms. As per the investment strategy, the investment manager will have the freedom to take a long position, or 'Buy' position, in under-priced stocks and a short position, or 'Sell' position, in over-priced stocks. These funds are also characterized as '130/30' funds, (or 120/20, as applicable) which means, the investment manager takes 130 percent long positions and 30 percent short positions, as a percentage of the total investable funds. This ensures that the net exposure to the market is equal to 100 percent of the value of total investable funds. The short positions are usually undertaken by investing through the options and futures contracts on the underlying assets.

In contrast with a Long-only Strategy, the investment manager can take a short position in stocks, even at the time of investments in stocks. This provides greater flexibility to the investment manager and can create a natural hedge against total market risk of the Category III AIF. This is possible if both short positions and long positions are taken in stocks, which have the same characteristics or in the same industry. Long-short Strategy can be volatile and risky, during economic downturns. Excessive leverage and short positions taken by the investment manager can also increase the volatility of the fund. Hence, SEBI restricts the leverage taken by Long-Short Funds, such that total exposure in long positions and short positions, net off any offsetting positions, is not more than 2 times the Assets under Management of the fund.

Let us understand the Long-short Strategy, using the following example.

Example 2: Long-short Strategy

Fund TCR is a Category III AIF, with a Long-short Investment Strategy. Investments are made in large-cap and mid-cap stocks, as well as derivative contracts. Analyse the investments made by the fund.

Positions in Stocks and Derivatives: As on April 01, 2020

Particulars	Exposure	Quantity	Market Price (Rs.)	Total Value (Rs.)
Stocks: Large-cap				
Company B	Buy	10,00,000	50	5,00,00,000
Company C	Sell	3,00,000	250	7,50,00,000
Company D	Buy	4,00,000	500	20,00,00,000
Stocks: Mid-cap				
Company E	Buy	1,00,000	500	5,00,00,000
Company F	Sell	1,00,000	930	9,30,00,000

Particulars	Strike Price	Lot-size (Contracts)	Quantity (Lots)	Market Price (Rs.)	Total Exposure (Rs.)
Put Options Bought					
NIFTY50: Expiry – 31 Dec 20	9000.00	450	50	500.00	1,12,50,000

Analysis:

As seen from the tables above, Fund TCR has taken Buy and Sell positions in Large-cap stocks and also hedged the risk, by taking adequate Put options in NIFTY50, with an expiry of December 31, 2020, which is nine months from the date of holding securities. However, the Fund has an additional exposure to Mid-cap stocks. The investment manager has taken a buy position in one stock and a sell position in one stock in the Mid-cap sector. However, such exposures are not perfectly offsetting the market risk and total exposure to the Mid-cap sector. Such exposure in the Mid-cap sector can significantly increase the total risk and volatility of the fund.

7.1.3 Market-Neutral Strategy

The Market-Neutral Strategy, like the Long-Short Strategy focuses on delivering absolute returns, by identifying over-priced and under-priced stocks, relative to the investment manager's fair valuation. The difference in Market-Neutral Strategy is that the Category III AIF has net 'zero' or 'neutral' exposure to a particular sector, industry or market-capitalization of companies in the equity market. As per the investment strategy, Category III AIF managers take equal amount of long and short exposures in Equities, through long positions, in under-priced stocks, and short positions, in over-priced stocks. As the Category III AIF is neutral to the broad-based market index, industry or sector, the 'Beta' or systematic risk of the fund is zero, or close to zero. Investment Managers may use either fundamental analysis or quantitative algorithms, to estimate growth of a company's stock, and take long or short positions, accordingly.

In contrast with Long-short Strategy, the investment manager of a Market Neutral Strategy will have to ensure that the Portfolio Beta is not significantly higher or lower than "Zero". A high Beta signifies greater volatility of the fund. Hence, the investment manager has low flexibility to trade freely in various stocks, by market-capitalization, industry or sector. Market-Neutral funds use long and short positions with the aim of minimizing the systematic risk of the portfolio, whereas, long-short funds use long and short positions with the aim of taking advantage of undervalued and overvalued opportunities.

A zero Beta does not ensure that the Strategy is not volatile or risky, during economic downturns. Excessive leverage and concentrated positions taken in stocks can also increase the volatility of the fund. Let us understand the Market-Neutral Strategy, using the following example.

Example 3: Market-Neutral Strategy

Fund PQC is a Category III AIF, with a Market-Neutral Investment Strategy. Investments are made in large-cap and mid-cap stocks, using derivative contracts or direct equity exposure. Analyse the investments made by the fund.

Positions in Stocks and Derivatives: As on April 01, 2020

Particulars	**Exposure**	**Quantity**	**Stock Beta**	**Market Price (Rs.)**	**Total Value (Rs.)**
Large-cap Stocks					
Company B	Buy	10,00,000	0.40	50	5,00,00,000
Company C	Buy	2,00,000	2.00	250	5,00,00,000
Company D	Sell	2,00,000	1.20	500	(10,00,00,000)
Net Exposure					**0.00**
Mid-cap Stocks					
Company E	Buy	1,00,000	1.50	500	5,00,00,000
Company F	Sell	1,00,000	1.50	500	(5,00,00,000)
Net Exposure					**0.00**

Particulars	Strike Price	Lot-size (Contracts)	Quantity (Lots)	Market Price (Rs.)
Index Options: Bought				
NIFTY50: Call Expiry – 31 Dec 20	10000.00	750	30	750.00
NIFTY50: Put Expiry – 31 Dec 20	9500.00	450	50	500.00

Analysis:

As seen from the tables above, the Fund PQC has taken Buy and Sell positions in Large-cap stocks as well Mid-cap stocks. The long and short exposures in both segments is neutral, as the total amount invested in Long positions in Large-cap stocks is equal to the total amount invested in Short positions in Large-cap stocks. Similarly, the total amount invested in Long positions in Mid-cap stocks is equal to the total amount invested in Short positions in Mid-cap stocks.

The portfolio beta is zero, as the total exposure to the broad-based market is neutral. The portfolio beta is computed as the total of weighted average of the stock-specific Beta, within each class of investments, computed as follows:

Particulars	Stock Beta [A]	Value of Investment	Weights* [B]	Weighted Average Beta [A*B]
Large-cap Stocks				
Company B	0.40	5,00,00,000	0.25	0.10
Company C	2.00	5,00,00,000	0.25	0.50
Company D	1.20	(10,00,00,000)	0.50	(0.60)
Total		**NIL**		**0.00**
Mid-cap Stocks				
Company E	1.50	5,00,00,000	0.50	**0.75**
Company F	1.50	(5,00,00,000)	0.50	**(0.75)**
Total		**NIL**		**0.00**

* Weights are computed by dividing the investment in the company, by the total investments in the sector-specific stocks, viz. large-cap stocks and mid-cap stocks

However, the exposures in individual stocks bear risk, unrelated to the market risk. This is also known as Unsystematic Risk. The individual price movements of each stock can significantly change the portfolio mix, as the investment manager will again need to bring the Portfolio Beta to Zero.

On analysing the positions in NIFTY50 options, it is observed that the fund has taken a Call Option on NIFTY50, with a Strike Price of 10,000 and a Put Option on NIFTY50, with a Strike Price of 9500. Expiry Dates for the Call option and Put option are same, i.e. December 31, 2020. Total exposure taken in terms of number of contracts is the same in Call Options and Put Options, i.e. 22,500 contracts. The Fund has neutralized the exposure to NIFTY50, for any value above 10,000 or any value below 9,500. However, the fund will be exposed to market risk, if the NIFTY50 value as on December 31, 2020 is between 9500 and 10000. Due to different strike prices of the NIFTY50 options, the portfolio beta is not zero. Hence, the positions taken in the derivatives contracts are NOT Market-Neutral, as observed in positions taken in Large-cap stocks and Mid-cap stocks. The Portfolio Beta, after taking into consideration all positions in equity markets and derivative markets, will be close to zero.

Practically, the portfolio beta will not remain exactly zero, for a Category III AIF following the Market-Neutral Strategy. For instance, in our example the portfolio beta was changed due to the Index Options taken on NIFTY50. If these options are taken for the purpose of hedging market risk, then a change in Portfolio Beta is justified. Hence, Portfolio Beta of close to zero is also justified, if a Category III AIF is pursuing a Market-Neutral Strategy.

7.1.4 Directional and Short-bias Strategies

A Directional Strategy focuses on delivering absolute returns for investors by taking either a net long position or a net short position in the selected stocks or a broad-based market index. The Category III AIF manager takes an investment call on the direction of the overall market, over the short-term or medium to long-term. If the investment manager has taken net long positions, the fund will benefit from an upward movement in the market, and vice-versa. A Directional Strategy is an opposite of Market-Neutral Strategy, as the investment manager will not aim at having a Portfolio Beta of zero or close to zero.

A Dedicated-Short Directional Strategy is a category of Directional Strategy, in which the investment manager exclusively takes short positions only. Similarly, a Dedicated-Long Directional Strategy is a category of Directional Strategy, in which the investment manager exclusively takes long positions only.

Short-bias Strategy is a type of Directional Strategy, wherein the investment manager takes both long and short positions in selected stocks or a broad-based market index, but maintains a net short exposure to the broad market. A Short-bias Strategy will also benefit from downward movement in the market.

Short-bias Strategy differs from a Long-only Strategy, as the fund maintains a net long exposure in a Long-only Strategy and net short exposure in a Short-bias Strategy. Similarly, in a Long-short Strategy, the investment manager may maintain a net long or a net short exposure, as compared to the net short exposure to be maintained in a Short-bias Strategy.

In a typical '130/30' long-short strategy, the investment manager maintains a net long position, up to 100 percent of the total investable funds.

The Dedicated-Long Strategy also differs from the long-short strategy. The investment manager may take both long and short positions in the long-short strategy, as compared to exclusively taking long positions in a Dedicated-Long Strategy. A Directional Strategy and a Short-bias Strategy may be volatile and risky, during major macro-economic upturns as well as downturns, depending on the net exposure taken by the investment manager. Let us understand the Directional Strategy and Short-bias Strategy, using the following example.

Example 4: Directional Strategy and Short-bias Strategy

Fund LMN and Fund TGR are Category III AIFs. Investments are made in large-cap stocks, mid-cap stocks, using derivative contracts or direct equity exposure. Identify the Investment Strategy pursued by both funds and analyse the investments made by the funds.

Fund LMN:

Positions in Stocks: As on April 01, 2020

Particulars	**Exposure**	**Quantity**	**Market Price (Rs.)**	**Total Value (Rs.)**
Large-cap Stocks				
Company C	Buy	2,00,000	250	5,00,00,000
Company D	Sell	2,00,000	500	(10,00,00,000)
Net Exposure:				**(5,00,00,000)**
Mid-cap Stocks				
Company E	Buy	1,00,000	500	5,00,00,000
Company F	Sell	1,50,000	500	(7,50,00,000)
Net Exposure:				**(2,50,00,000)**

Fund TGR:

Positions in Stocks: As on April 01, 2020

Particulars	**Exposure**	**Quantity**	**Market Price (Rs.)**	**Total Value (Rs.)**
Large-cap Stocks				
Company H	Buy	5,00,000	700	35,00,00,000
Company I	Buy	2,00,000	1500	30,00,00,000
Net Exposure:				**65,00,00,000**

Equity Derivatives Exposures: As on April 01, 2020

Particulars	Strike Price	Lot-size (Contracts)	Quantity (Lots)	Market Price (Rs.)
Index Options: Bought				
NIFTY50: Call Expiry – 31 Dec 20	10000.00	750	30	750.00
NIFTY50: Call Expiry – 31 Dec 20	9500.00	750	50	805.00

Analysis:

As seen from the tables above:

- Fund LMN is pursuing a Short-bias Strategy. The fund has net short positions in Large-cap stocks as well as Mid-cap stocks.

- Fund TGR is pursuing a Directional Strategy, particularly a Dedicated-Long Directional Strategy. The fund has bought shares of large-cap stocks as well as taken Call Options on the broad market index – NIFTY50, for a later expiry date, which indicates that the fund will profit if the NIFTY50 value increases.

7.2 Global-Macro Strategy

Unlike Equity Market Strategies discussed above, Category III AIFs pursuing a Global Macro Investment Strategy can take both long and short positions across asset classes such as currencies, fixed income securities, equities, commodities, real assets and interest rate derivatives. The objective of the fund will be to earn positive absolute returns for the investors, by investing in multiple markets and geographies. Global-Macro Strategies helps a fund to diversify across multiple asset classes and manage total risk of the fund portfolio.

The investment manager makes stock selection primarily on the basis of macro-economic trends and factors, instead of fundamental analysis of historical data of every company. Major players in the Category III AIF market have advanced Algorithms to analyse macro-economic trends on multiple dimensions, utilizing both quantitative and discretionary inputs.

The fund may apply a long-only strategy, market-neutral strategy, directional strategy or a long-short strategy to invest across multiple markets, asset classes and geographies. For example, a global macro investment manager may decide to take long positions in Indian corporate debt securities, short positions in Euro, long positions in U.S. T-bills and stay market-neutral when investing in Crude, subject to regulatory guidelines published from time to time. Let us understand the Global Macro Strategy, using the following example.

Example 5: Global-macro Strategy

Fund GMS is a Category III AIF, with the following holdings, as on April 30, 2020. Identify the Investment Strategy pursued by the fund and analyse the investments made by the fund.

Particulars	**Exposure**	**Quantity**	**Market Price (Rs.)**	**Total Value (Rs.)**
Large-cap Stocks				
Company J	Buy	2,00,000	1,000	20,00,00,000
Company K	Buy	1,00,000	2,250	22,50,00,000
Mid-cap Stocks				
Company E	Buy	10,000	500	50,00,000
Company F	Buy	10,000	500	50,00,000

Other Exposures: Currency

Particulars	**Lot-size (Contracts)**	**Quantity (Lots)**	**Futures Price**
Currency Futures: Short Positions			
USDINR 20MAYFUT	1000	150	75.20
GBPINR 20MAYFUT	1000	150	94.10

Other Exposures: Crude Oil

Particulars	**Lot-size (Barrels)**	**Quantity (Lots)**	**Futures Price**
Commodity Futures: Long Positions for Settlement			
Crude Oil WTI	1000	10,000	1333

Analysis:

As seen from the tables above:

- Fund GMS is pursuing a Global-macro Strategy, as it has invested across multiple asset classes, being Indian Stocks, currency derivatives and crude oil futures. Long positions are taken in equities and oil contracts, while short positions are taken in currency derivatives. Since the fund has a net long exposure, it can be concluded that the Investment Strategy is a Long-Short strategy.

- Exposure in multiple markets and multiple asset classes are also taken by the fund. A long position in the WTI Oil Futures contract signifies that the investment manager is bullish on oil and equity asset class.

7.3 Convertible Arbitrage Strategy

Convertible Arbitrage Strategy is a type of long-short strategy used by a Category III AIF, to benefit from the mispricing of a Convertible Debt or Convertible Preference share of a company, which are called as Convertible Securities or Hybrid Securities. A convertible security is a hybrid debt or preference share issued by a company, which gives an option to its holder to convert the security into equity shares at a pre-determined date and a conversion ratio based on the pre-determined price of the equity share. If an investor purchases such convertible securities, such investor can continue to hold the convertible security and receive coupons, or choose to convert the security to equity shares, on the Exercise Date and at Exercise Price of the option.

A Category III AIF pursuing the Convertible Arbitrage strategy will take a long position in convertible securities issued by a company and simultaneously take a short position in the same company's equity shares. This Strategy is pursued to earn a riskless profit, independent of stock price movements, known as Convertible Arbitrage. If the equity share price falls, the fund will benefit from its short position and continue to earn fixed income, in the form of coupons on the convertible security. On the other hand, if the equity share price rises, the fund can choose to convert its convertible security into equity shares and sell the equity shares at market value, which can compensate for any losses on the short position taken in equity shares.

The idea behind convertible arbitrage is that a company's convertible bonds are sometimes priced inefficiently relative to the company's equity shares. The pricing is determined by the Conversion Ratio, inherent in the convertible security. A Category III AIF can attempt to profit from pricing errors in the convertible securities. Convertible Arbitrage is difficult to implement and can be riskier, especially at times of changing macro-economic factors and unpredictable events. The market factors, economic cycles and company fundamentals play an important role for the Convertible Arbitrage to be implemented successfully. Let us understand the Convertible Arbitrage Strategy, using the following example.

Example 6: Convertible Arbitrage Strategy

Fund CAS is a Category III AIF, which is pursuing a Convertible Arbitrage Strategy while investing in Corporate Bonds of Company A. Analyse the profits earned by the fund.

Particulars	Amount
Data as on April 01, 2020:	
Long: 12% Convertible Bond – Face Value of Rs. 1,000	Rs. 1,00,00,000
Conversion Ratio (after 1-year lock-in of investment)	25:1
Capital Invested	Rs. 20,00,000
Borrowed Capital @ 10% p.a.	Rs. 80,00,000
Short positions in equity shares of Company A	50,000 equity shares
Face Value of Equity share of Company A	Rs. 5/share
Equity Share Price – as on April 01, 2020	Rs. 40
Borrowing Fee – For Short Positions in Equity Shares	Rs. 5/share
Data as on March 31, 2021:	
Dividend declared on Equity shares	Rs. 2/share
Convertible Bond Price	Rs. 1,050
Equity Share Price	Rs. 42.50

Analysis:

Fund CAS has taken long positions in Convertible Bonds and short positions in equity shares of Company A.

The total investment in Bonds was Rs. 1,00,00,000. The investment was financed by 20% fund capital and 80% borrowed capital. Conversion Ratio is 25:1, which indicates 25 equity shares will be issued for every bond of Rs. 1,000 face value, on the exercise date. Based on the Market Price of Equity Shares, as on April 01, 2020, the value of 25 equity shares is Rs. 1,000, which equates the Face Value of Rs. 1,000 of the Convertible Bond. This indicates that the Conversion Ratio is fairly priced.

On implementation of the Convertible Arbitrage Strategy, the following incomes/loss and expenses shall accrue for Fund CAS, during the period April 01, 2020 to March 31, 2021:

Particulars	Calculation	Amount (Rs.)
Income/(Expenses):		
Borrowing Cost – On Borrowed Capital	Rs. 80,00,000 @ 10% pa (Interest for 1 year)	(8,00,000)
Coupon Interest on the Bond	Rs. 1,00,00,000 @ 12%	12,00,000
Borrowing Fees – On Short Equity Positions	50,000 shares @ Rs. 5/share (Fees for 50,000 equity shares)	(2,50,000)
Dividend Foregone – On Short Equity Positions	50,000 shares @ Rs. 2/share (Fees for 50,000 equity shares)	(1,00,000)
Exit Value of Long/(Short) positions:		

Profit on Conversion of Bonds	2,50,000 shares @ Rs. 42.50/share Less: Investment Rs. 1,00,00,000	6,25,000
Loss of Squaring-off Short Positions in Equity	50,000 shares @ Rs. 2.50/share (Difference of Rs. 42.50 - Rs. 40.00)	(1,25,000)
	Total Income / (Loss)	**5,50,000**
	Total Fund Investment	**20,00,000**
	Return on Investment (ROI)	**27.50 %**

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

- The Fund CAS has been successfully able to implement the Convertible Arbitrage Strategy, by anticipating the change in expected equity price of the Company. The Conversion Ratio was fairly valued at the beginning of the year, but was mispriced by the end of the year due to increase in the price of the equity shares.

- If the price of equity shares would have decreased, the Fund would not choose to convert the bonds into equity and square-off the short position in equity shares, with a net gain of 15%.

- Borrowing Fees is the Fees incurred by the Fund, in order to borrow the securities for the purpose of short positions or short sale. This is an additional cost to the Fund. Similarly, dividends declared by the company will not accrue to the investor, as the investor has a short position in the equity shares. Borrowing Cost of 10% will be incurred to the extent of leverage taken by the fund, when investing in the Convertible Bonds. However, the coupon interest on the bond will be an additional risk-free income for the fund.

7.4 Event-driven Investment Strategies

Event-driven Investment Strategy followed by Category III AIFs involves taking positions in Equities or Derivatives contracts of one target company, pursuant to a significant corporate event at the Company, such as Debt re-structuring, Mergers, Acquisitions, Spin-offs or change in management of the company. Such significant changes in the Company impact the market price of the Equity shares or Fixed Income securities of the company under consideration. Event-driven Investment Strategy may involve taking both long positions and short positions in Equities or Fixed Income Securities, unlike Equity-Market Strategy. The primary indicator for implementing the Event-driven Strategy is a material corporate event. Common types of Event-driven Investment Strategies are explained below:

7.4.1 Activist Strategy

An Activist Strategy is implemented by a Category III AIF, to make a significant investment in an investee company and benefit from a material corporate event in that investee company.

Material corporate events such as change in management teams, filing for bankruptcy or shutting down one business segment, may lead to a significant decrease in equity prices of the company. If a Category III AIF manager estimates that the fund can earn profits, by changing the operational efficiency of an investee company, significant funds are invested in that investee company which can enable the fund to participate in the management process of the investee company. Such Category III AIFs are also known as Activist Funds, who take a private equity approach and a long-term oriented approach to make investments.

Under the stewardship code released by SEBI, all Alternative Investment Funds are required to actively monitor their investee companies and vote in important company matters. All Alternative Investment Funds should also have a clear policy for collaboration with other institutional investors, in order to preserve the interests of the ultimate investors.

Activist Funds differ from traditional funds by having a less diversified portfolio and illiquid investments. In India, SEBI has placed concentration limits on Category III AIFs, to invest not more than 10 percent of its Investable Funds or its NAV, in one single investee company. Activist Strategy is yet in the nascent stages of investments. As the investments involve a big capital commitment, Large Value Funds are most suitable for implementing this strategy. SEBI has relaxed the concentration limits for Large Value Funds, which can invest not more than 20 percent of its Investable Funds or its NAV, in one single investee company. Given the concentration limits, Indian Category III AIFs are typically able to invest in small-cap or mid-cap companies which have a high failure risk, especially when the investment manager is looking to take a substantial stake and turnaround the company.

7.4.2 Merger Arbitrage Strategy

Merger Arbitrage Strategy is a type of an Event-driven strategy used by a Category III AIF, to benefit from the Merger or Acquisition of one 'Target' Company by an 'Acquiring' Company. In a Merger or Acquisition process, the company buying the shares of another company is known as the Acquiring Company. Likewise, the company selling its shares or being merged into an Acquiring Company is known as the Target Company.

A Category III AIF pursuing the Merger Arbitrage strategy will take a long position in equity shares issued by the Target Company and simultaneously take a short or long position in the equity shares issued by the Acquiring Company. This Strategy is pursued to earn an arbitrage profit from stock movements in the Target Company and Acquiring Company.

When an Acquiring Company provides its best offer in the merger or acquisition deal to the Target Company, it typically needs to pay a premium over the Target Company's unaffected equity share price, or the current share price before the deal. This premium is necessary because such Target Company's board of directors is only likely to approve the acquisition of the company, if the Acquisition Price is significantly higher than the current equity share price of the company. Hence, a long position is taken in the equity shares of the Target Company, to capitalize on the spread between the Target Company's current share price and the Acquisition Price, on completion of the deal.

Similarly, a short position is taken in the equity shares of the Acquiring Company primarily on account of two reasons:

- **Uncertainty in deal-completion:** Till the final allotment of shares by the Acquiring Company, there is a risk that the deal may not be approved by the Target Company or the concerned regulatory authorities. From the date of announcement of the merger or acquisition deal, the process of taking board approvals, regulatory approvals and shareholder approvals, are initiated. If at any stage, the deal is not approved or is delayed, there is a high risk that the deal can fail.

- **Premium to Target Company**: If the premium to be paid to the Target Company is over-valued, there is an inherent risk that the equity share price of the Acquiring Company will fall. Conversely, if the Premium paid is under-valued, there is a high probability of the equity share price rising, for the Acquiring Company. The valuation method adopted to compute the Fair Market Value of one share of the Target Company, would impact the conversion ratio and hence, could lead to arbitrage

Merger Arbitrage Strategy can be successfully implemented by a Category III AIF, if the investment manager can estimate the fair value of the premium to be paid by the Acquiring Company, which decides the Conversion Ratio to be offered, and accordingly take long or short positions in the equity shares of the Acquiring Company. Like any other strategy, Merger Arbitrage Strategy can be risky on account of changing macro-economic factors and unpredictable events in the company. Market factors, economic cycles and company fundamentals play an important role for the Merger Arbitrage to be implemented successfully. Let us understand the Merger Arbitrage Strategy, using the following example.

Example 7: Merger Arbitrage Strategy

Fund MAS is a Category III AIF, which is pursuing a Merger Arbitrage Strategy while investing in Equity Shares of Company ID and Company CF. Merger of Company CF in Company ID is announced on January 15, 2018. Both Company Boards have approved the merger.

Analyse the stock positions taken by the fund.

Particulars	**Amount**
Data as on January 15, 2018:11:00:00 AM	
Acquiring Company ID – Equity Share Price	Rs. 540.00
Target Company CF – Equity Share Price	Rs. 39.25
Announcement of Merger Deal on January 15, 2018 at 11:01:00 AM	
Company ID to acquire Company CF, in a full-stock deal	
Conversion Ratio	139 : 10
Data as on January 15, 2018: 03:30 PM (Closing Prices)	
Acquiring Company ID – Equity Share Price	Rs. 567.80

Target Company CF – Equity Share Price	Rs. 41.00
Positions taken by Fund MAS on January 15, 2018 at 11:02:00 AM	
Buy 1 lakh equity shares of Company CF @ Rs. 540/share	Rs. 5.400 crore
Buy 10 lakh equity shares of Company ID @ Rs. 39.25/share	Rs. 3.925 crore

Analysis:

Merger of Company CF, into Company ID has already been approved by both the Boards and the regulators, as stated above. Hence, the risk of the deal failure is minimal. In such a case, the Fund should ideally take long positions in equity shares of the Acquiring Company also.

Within a minute of the announcement of the deal, Fund MAS has taken BUY positions in equity shares of Company CF, i.e. the Target Company, and equity shares of Company ID, i.e. the Acquiring Company. Profit earned by the Fund is as follows:

Particulars	**Investment (Rs.)**	**No. of Shares**	**Closing Price (Rs.)**	**Total Value (Rs.)**
Equity Shares:				
Company CF	5,40,00,000	1,00,000	567.80	5,67,80,000
Company ID	3,92,50,000	10,00,000	41.00	4,10,00,000
		Total Value		**9,77,80,000**
		Total Investments		**9,32,50,000**
		Return on Investment (%)		**4.86%**

As seen from the table above, Fund MAS has generated a 4.86% within one day, by successfully implementing the Merger Arbitrage Strategy:

The Investment manager was successful in analysing the market and making the right investment call to take a long position in the equity shares of Company ID. This can be done by valuing the security, based on the Conversion Ratio agreed in the Merger. Conversion Ratio was 139:10 i.e. shareholders of Company CF will be issued 139 shares of Company ID, for every 10 shares in the company.

Based on the calculations using equity share prices as on January 15, 2018**: 11:00:00 AM**, we can calculate the fair value of the Acquiring Company, as follows:

Fair Price of Company ID = $\frac{139*39.25}{10}$= **Rs. 545.58**

Market Price of Company ID = **Rs. 540.00**

Since the equity shares of Company ID are under-valued, based on the Conversion Ratio offered in the Merger Transaction, the investment manager should BUY the equity shares of Company ID. Hence, the stock positions taken by the investment manager is justified.

7.4.3 Pre-IPO Strategy

An Initial Public Offering (IPO) refers to the time when a company goes public for the first time and offers its shares to investors in the primary stock market. It is the initial sale of stock that a company issues to the public. Pre-IPO shares are the specific shares, with unique identification numbers, issued to the employees or institutional investors in the company, including Category III AIFs, before such shares are offered to the general public, in an IPO. Pre-IPO shares are offered to institutional investors at a discount to the issue price of equity securities in the IPO, due to sufficiently large amount of investments made and risk taken by such institutional investors. Pre-IPO Placement is the process of allotment of Pre-IPO shares to certain institutional investors, just before the date of the IPO of the investee company.

A Category III AIF pursuing a Pre-IPO Strategy is a fund which has the mandate to subscribe to Pre-IPO shares of an investee company, at a discount from the issue price of the equity securities in the IPO. As per the SEBI (Issue of Capital and Disclosure Requirements) Regulations, 2018 institutional investors including Category III AIFs, subscribing to Pre-IPO shares or a Qualified Institutions Placement (QIP), are subject to a minimum lock-in period of 6 months, from the date of listing of such shares through an IPO, by the investee company. In case of fresh issue of equity shares, if 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.[129]

Let us understand Pre-IPO Strategy with the following example:

Example 8: Pre-IPO Strategy

Fund PPI is a Category III AIF pursuing a Pre-IPO Strategy while investing in Equity Shares of a privately-held Company ABC. Fund PPI had invested in the Company through a Private Placement, on January 15, 2020 and bought 2,50,000 shares of the Company from the promoter, at Rs. 120/share.

Company ABC announced an IPO of 10,00,000 shares with an Issue Price of Rs. 130 per share, which was completed on June 15, 2020 and shares were allotted to the respective allottees. The following table shows the shareholding pattern of Company ABC, post the IPO.

Particulars	**No. of Shares Held**	**Offer Price (Rs.)**	**% of Holding**
Institutional Investors			
Fund PPI	2,50,000	120	16.67%
Mutual Funds	1,50,000	130	10.00%
Non-Institutional Investors	2,00,000	130	13.33%

[129]As per Securities and Exchange Board of India (Issue of Capital and Disclosure Requirements) (Third Amendment) Regulations, 2021

Retail Individual Investors	3,50,000	130	23.33%
Promoter Holding	5,50,000	NA	36.67%
Total Holding	**15,00,000**		**100%**

Analyse the investment made by Fund PPI.

Analysis:

Fund PPI follows a Pre-IPO Strategy. It has subscribed to shares of a privately-held company, at a significant discount to the Issue Price for the IPO of Company ABC. The discount received is Rs. 10 per share or 7.70% off the Issue Price, for taking a 16.67% stake in the Company. The shares held by the Fund will be locked-in for a period of 6 months, from the date of listing of shares pursuant to the IPO, i.e. June 15, 2020.

On observation of the total post-IPO shareholding for Company ABC, it can be observed that the Total number of outstanding shares are 15,00,000, out of which 5,50,000 shares are retained by the promoters of the company,7,00,000 shares are issued through the IPO process and 2,50,000 shares were issued as Pre-IPO shares to Fund PPI.

7.5 Due Diligence Process

Category III AIFs seek capital commitments from sophisticated investors and institutional investors. These investors may be High Net worth Individuals or Institutions such as Endowments, Foundations, Pension Funds, Sovereign Wealth Funds, Banks, Financial Institutions, Insurance Companies and other corporate entities. Corporate Institutions have a pre-defined methodology for screening a potential investment. Such institutions seek for 'Red Flags' or any internal and external factors that may materially impact the stated risk-return objective of the investment. This process is known as "Due Diligence" and the investors conduct due diligence in the following manner, before investing in a potential Category III AIF.

Investment Due Diligence

Investment Due Diligence is done to analyse the financial performance and factors influencing the financial performance of a Category III AIF, in order to verify the expected return and risk factors stated by the fund in its Private Placement Memorandum. Macro-economic factors as well as business-related factors of the Category III AIF are crucial, to conduct the Investment Due Diligence.

Some of the points taken into consideration for conducting the Investment Due Diligence are briefly mentioned below:

1. **Investment Strategy**

The stated Investment Strategy is analysed to check for the investment methodology and risk factors involved while investing in targeted securities, such as excessive limits on short positions, excessive derivative-trading and concentration limits. In case of a Category III AIF, leverage is also a crucial factor for investors, which may increase the potential risk of the Fund portfolio, as seen in the classic case of Long Term Capital Management Fund, in USA. (see Box 7.1)

Box 7.1: Long Term Capital Management Case
Long Term Capital Management (LTCM) was set-up by John Meriwether from Salomon Brothers. The Fund had a very long track record of highly profitable relative-value strategies. It used to perform convergence trades in the European, Japanese and USA Sovereign Bond Markets, by purchasing relatively under-valued bonds and selling relatively over-valued bonds. For the fund to make significant profit, it needed to make many highly-leveraged positions. This was because the difference between the converging trades was miniscule. By 1998, the fund had equity of USD 5 billion and had borrowed over USD 125 billion, operating at a leverage ratio of 30:1. The Russian sovereign debt had defaulted in the summer of 1998, which drove a rapid flight to quality in treasuries, and the source of their relative value profits turned into a significant loss position. These losses were compounded by the high leverage taken by the fund. LTCM was forced to liquidate all holdings and close. There was fear that the downfall of LTCM could have spiraling effects in the global financial markets, causing catastrophic losses throughout the financial system. Goldman Sachs, AIG and Berkshire Hathaway on September 23, 1998 offered to buy out the funds partners for USD 250 million and decided to inject USD 3.75 billion and to operate LTCM within Goldman's own trading division. The final bailout was USD 3.65 billion. The downside trigger on account of the Russian default caused the demise of LTCM due to the leverage deployed and the sheer size of their positions relative to the broader market.

2. **Investment Management Team**

The Investment Manager should have relevant exposure and experience in the same asset class of securities, in which the fund is making targeted investments as the investment strategy. Experience of minimum five years is compulsory, in investment management or investment advisory services, as per the SEBI (Alternative Investment Funds) Regulations, 2012. The minutes of the Investment Committee meetings should also be reviewed, to check the investment management and approval process adopted by the Fund.

The past experience of the Investment Management team is also equally important. Investment Due Diligence should also include reviewing the past investment experience of the team inter-alia involved in equity research, trade execution, order management, sales, compliance and fund administration.

3. **Manager Selection Process**

Manager Selection Process adopted by the Category III AIF is one of the most crucial factors reviewed in an Investment Due Diligence process. Investment manager is a 'Key Person' of the Category III AIF and the investors should ensure that selection of the manager is done through a proper screening and selection process. An informal process of appointment of the investment manager may indicate that the fund is privately managed, by the sponsor and manager, without aligning the interest of the investors.

4. **Past Track Record of the Investment Manager**

Historical Performance of the funds/investments previously managed by the Investment Manager should be thoroughly analysed. Potential investors in the Category III AIF should analyse the historical returns of the funds managed by the investment manager, over a minimum of five years. Investors should verify if the investment manager had successfully managed a sizeable fund corpus, provided stellar returns for investors in that fund and invested across the same asset classes and industries, as targeted by the Category III AIF.

5. **Past Disciplinary History**

The Investment Manager and Sponsor of the Category III AIF, along-with its respective partners, directors, associates and Trustees should not have a history of outstanding litigation cases, where the person has been found guilty, for a minimum period of five years. Investors should also check for any history of criminal or civil prosecution, disputes, non-payment of statutory dues, past defaults against banks or financial institutions, proceedings initiated for economic offences or civil offences, any disciplinary action taken by SEBI or any other regulatory authority, penalties levied and disputed tax liabilities to be paid thereof.

6. **Key-Person Risk**

In a Category III AIF, the investment managers are key persons for the fund, making all the investment decisions, fulfilling redemption requests, ensuring compliance and seamless trade execution. Any adverse event, such as death, insanity, incapacity or immovability of the investment manager can significantly hamper the operational activities of the fund and thereby, posing a threat to the net return earned by the investors.

Investors, either directly or through their authorized representatives/consultants, should hold on-site meetings with the investment manager and the entire team of investment management, trade execution, research and compliance. This can help the investor to analyse the functions of every member within the team and analyse if the fund is dependent on the actions of only the investment manager.

7. Alignment of Interest

The inherent conflict of interests of a Category III AIF with its investors is a major concern and raises a Red Flag in the Due Diligence process. Investment Managers of a Category III AIF should ensure that the interest of investors in the fund is not compromised at any point during the life-time of the fund, in order to make gains in the proprietary account of the investment manager or gains for affiliate entities of the fund. This is possible in the following manner:

- Making investments through the Category III AIF in such entities, in which the affiliates, investment manager and other interested parties may have a previous ownership interest, whether or the same terms or otherwise.
- The Investment Manager should dedicate their time towards making investment management decisions for the Category III AIF. Allocation of time and resources by the investment manager, amongst any other projects is a conflict.
- The Investment Manager may allocate potential investment opportunities, among the Category III AIF, other co-investors and other funds managed by the investment manager.
- The Investment Manager may in its sole discretion offer other funds an opportunity to co-invest along-with the Category III AIF in particular investments. If the terms on which co-investors participate in investments are different from the terms on which the Fund participates in those investments, there is a potential conflict of interest.

The Investment Manager should avoid any such potential conflicts of interest, thereby aligning the interest of the investors with the fund.

8. Fee Structure of the Fund

A higher fee-structure, if adopted, by the Investment manager should be justified by the past performance, industry exposure and reputation of the investment manager, in the domestic capital market. If the past performance is not significantly high, a higher fee structure would be undesirable and would be a potential risk factor for the investors.

Institutional Investors would also review the fee structure applicable for all class of units to be issued by the Category III AIF. Investment Managers offering a fee structure with lower Management Fees and higher Incentive Fees may be preferred by some institutional investors, based on their risk appetite. Other risk-averse investors may prefer the standard rates for Management Fees and a lower Incentive Fee, to avoid taking excess risk.

9. Risk Factors and Leverage

Risk Factors mentioned in the Private Placement Memorandum (PPM) should be carefully analysed for any unnecessary risks and warranties claimed by the Fund. The investors should have the knowledge of permissible concentration limits, limits on short positions and limits on leverage taken by the Fund. A Fund may choose to have self-imposed restrictions on sectoral limits, type of securities to invest in and targeted market segments, among others, as per the PPM. SEBI has prescribed maximum leverage limits for a Category III AIF, in relation to its Net Asset Value.

10. Risk Management Controls and Policies

Risk Management policies of the fund outline the procedures to be adopted by the Category III AIF, in case of any breach in prudential norms prescribed by SEBI and the team members responsible to do so. The internal controls on pay-in and pay-out of cash and securities should be carefully analysed, to ensure that adequate safety measures and authentication policies are adopted by the fund, when executing trades.

11. Government Reforms and Taxation

Government Reforms in India have encouraged the growth of Category III AIFs. Investors should analyse the impact of current and expected government policies and taxation structures, on the net return of the fund and the distributions made to the investors. Compliance with taxation policies and timely payment of indirect taxes and direct taxes is an indicator of strong operational policies within the fund.

12. Macro-economic Factors

Economic cycles, global risk factors and political risks are crucial, for the Investment Strategy of the Category III AIF to be implemented successfully. Investors should analyse the possibility of negative returns and worst-case scenarios, such as war, pandemic, and domestic geo-political risk factors impacting potential returns.

13. Regulatory Compliance and Legal Proceedings

Investors should verify timely compliance of domestic regulatory norms, by the potential Category III AIF, in terms of Registration with the domestic regulator, compliance with prudential and reporting norms and timely payment of applicable taxes. Any legal proceedings against the fund may also result in contingent liabilities for the fund, thereby impacting the net distribution of funds to investors.

14. Business Operations and Internal Controls

Effective Operational Controls and Internal Controls are a pre-condition in today’s financial markets, for managing investors’ money. A Category III AIF should document all the internal policies and processes for every department within the fund. The investors must ensure that the fund has all basic controls, such as maker-checker control and access controls when handling confidential data relating to the clients.

15. Engagements with Third-party Service Providers

All Category III AIFs appoint external service providers such as a fund administrator, custodian, registrar and transfer agent, auditor, legal advisor, fund distributors, software developer and other professional service providers. Investors should verify the potential conflicts of interests with all service providers, in form of related party transactions, understand the important terms of contract and verify that the interests of the service providers are aligned with the interests of the investors in the Category III AIF.

16. Business Continuity and Disaster Recovery Plans

Business Continuity can be impacted, due to material Key-Person events or natural disasters. The investors should ensure that Category III AIFs have adequate business continuity plans and policies, which outline the future course of action on account of unpredictable events. Disaster Recovery Plans are also crucial for a Category III AIF with the increased use of technology for the purpose of executing trades and maintaining client's data.

17. Environmental, Social and Governance (ESG) Policies

Institutional investors should analyse the ESG policies adopted by the fund. If a potential Category III AIF manager has a reputation of being unprofessional at workplace, not providing adequate workplace safety to employee, then investors would prefer to not invest in the fund. Similarly, if a Category III AIF is unable to fulfil all the Corporate Governance requirements, such as following transparency norms for timely disclosures of information to investors, holding Investment Committee meetings on a timely basis or appointing independent directors on the Board, the investors would prefer not to invest in the fund with inadequate governance policies. Under the new stewardship code, released by SEBI, all Category III AIFs, in collaboration with other institutional investors, are required to monitor and engage with the investee companies on ESG factors and monitor the inherent ESG risks at the investee company level.

18. Potential Conflicts of Interest

The potential conflict of interests are identified by the Investment manager and disclosed in the PPM, before the investors commit capital. The conflicts may be internal conflicts with the fund sponsor, investment manager, affiliates and trustees, or external conflicts, with custodians and third-party service providers. Investors should carefully analyse every potential conflict and its impact on the estimated returns of the fund. Most Category III AIFs have a conflict resolution policy outlined in the PPM.

19. Transparency and Investor Reporting process

Institutional Investors always prefer timely disclosure of information, relating to the investments made by the fund, total short positions taken, concentration limits and total leverage taken by the fund. The Category III AIFs should provide timely disclosures to the investors, on a monthly, quarterly or yearly basis, in the formats prescribed by SEBI. A Category III AIF may choose to report more frequently than the prescribed limits of quarterly reporting or monthly reporting, to give comfort to investors. Category III AIFs which do not undertake Leverage are required to submit reports on a quarterly basis to SEBI, within 10 calendar days from the end of each quarter in the revised format as specified by SEBI. Category III AIFs which undertake Leverage are required to submit reports on a monthly basis to SEBI.

The investors conduct a thorough review of such other factors as necessary and conduct on-site visits, whenever possible, to physically verify the existence of staff members, policies and procedures claimed by the Category III AIF. Such process may be done internally, by appointing a dedicated team of due diligence professionals, having industry experience in legal and financial domain. Alternatively, some small-size and mid-size institutional investors may choose to appoint third-party due diligence experts, with qualified and dedicated staff in areas, inter-alia including investment management, finance, legal and regulatory compliance.

Investment Due Diligence is performed by Institutional Investors, after screening potential funds, based on pre-determined risk-returns objectives, and short-listing the target Category III AIF for a potential investment. Due Diligence process should be ideally completed before signing legal documents and investment agreements, which binds the institutional investor to commit capital to the fund. Timely completion of due diligence can allow the investor to negotiate the terms and conditions for subscription to the fund, based on the due diligence reports and analysis. Some of the important legal documents signed or to be verified by institutional investors and important points for consideration are outlined below:

- **Subscription Agreement/ Contribution Agreement:**

Subscription Agreement records the fund terms and conditions, distribution mechanism, list of expenses to be borne by the fund and powers of the investment committee of the Category III AIF. The agreement sets out the capital commitment for investors and records the representations and warranties to be made by the investors, on their legal qualification to make investments in the fund. A potential investor shall verify all the terms and conditions stated in the Subscription Agreement with the Private Placement Memorandum and check for any differences or discrepancies which may impact their rights or liabilities.

- **Advisory Agreement:**

A Category III AIF, based in an International Financial Services Centre (IFSC) as per the SEBI (International Financial Services Centre) Guidelines, 2015, such as Gujarat International

Finance Tec-City (GIFT), and foreign investors investing in Category III AIFs may choose to delegate the investment management and advisory function to a third-party, known as the Investment Advisor. The Investment Advisory Agreement contains the general terms under which such investment advisor renders advise in respect of the transactions for the Fund's board. A potential institutional investor shall review the professional qualification and experience of the third-party advisors appointed, the terms and conditions for such appointment and any potential conflicts of interest.

- **Indenture of Trust:**

The Indenture of Trust, or "Trust Deed", is an important document to determine the tax liability of institutional investors and the beneficial ownership in the "Trust" structure of a Category III AIF. The document mentions the nature of the trust, being a "Determinate Trust" or "Indeterminate Trust" and the applicability of tax rates, based on the trust structure. A potential institutional investor shall review the Indenture of Trust to ascertain their legal beneficial ownership, in the Category III AIF which is structured as a trust. Such investors can also ascertain the applicable tax rates, on income earned on the investment, whether to be paid by the fund or by the investor.

- **Private Placement Memorandum (PPM) and Wrapper:**

PPM outlines the investment thesis of a Category III AIF and summarizes the key terms on which institutional investors could participate in the units issued by the scheme. Potential risk factors and conflicts of interest are also outlined in the PPM. A wrapper is a supplement attached to the PPM, to help achieve compliance with the requirements for private placement of the units issued by an offshore fund, as per the compliances and regulations applicable within that jurisdiction. The PPM and Wrapper should be analyzed together, in order to shortlist a potential Category III AIF, established outside India.

- **Investor Side Letters:**

Investor Side Letters outline the preferential terms and exemptions provided to certain "Class" of investors. Such class of investors may seek differential arrangements with respect to lower management fee, participation in investment committee meetings or tax exemptions. An institutional investor can negotiate Investor Side Letters, based on the Due Diligence reports and analysis.

The Investment manager shall take into consideration the terms and conditions at which units are issued to investors. As per the Investor Side Letters, the fund may issue a unique "Class of Units" to those investors being offered differential terms to subscribe to the fund. However, it is important to note that the investment manager of a Category III AIF 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. One large investor cannot be given priority over other investors, in case a Category III AIF is distributing losses accumulated in the fund.

Chapter 7: Sample Questions

1. **In which of the following investment strategies would the investment manager only take BUY positions in the selected stocks, at the time of investment?**

    a. Long-short Strategy
    b. Market-Neutral Strategy
    c. **Long-only Strategy**
    d. Global Macro Strategy

2. **The difference between the Long-short Strategy and the Market-Neutral Strategy is that the Category III AIF has net 'zero' or 'neutral' exposure to a particular sector in the equity markets. State whether True or False.**

    a. **True**
    b. False

3. **_________is a strategy used by a Category III AIF to benefit from the mispricing of a debt security or a preference share of a company, in relation to its equity share.**

    a. **Convertible Arbitrage Strategy**
    b. Merger Arbitrage Strategy
    c. Pre-IPO Strategy
    d. Activist Strategy

4. **Which document is prepared to outline the preferential terms and exemptions provided to certain investors in the fund?**

    a. Private Placement Memorandum
    b. Advisory Agreement
    c. Subscription Agreement
    d. **Investor Side Letters**

5. **A Dedicated-Short Directional Strategy is a category of Directional Strategy, in which the investment manager exclusively takes buy positions only. State whether True or False.**

    a. True
    b. **False**

Chapter 8: Valuation

LEARNING OBJECTIVES:
After studying this chapter, you should know about:

- Concepts of Net Asset Value (NAV) and Mark-to-Market (MTM) process
- Valuation techniques to compute NAV of underlying portfolio of:
    - Liquid and Illiquid securities
    - Equity and Commodity Derivatives
    - Money Market instruments
    - Long term fixed securities
- Computation of NAV attributable to a Series of Units issued to Investors
- Role of third-party registered Valuers

8.1 Net Asset Value

As per SEBI (Alternative Investment Funds) Regulations, every Category III 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 and on a monthly basis for open-ended AIFs. Investors in the Category III AIF are to be provided with a description of the valuation procedure, the methodology of valuation and changes to such valuation methodology, if any, in relation to the Category III AIF.

For the purpose of understanding NAV, let us understand the following concepts:

- **Valuation Day**: The Valuation Day is pre-determined by a Category III AIF, and communicated to the investors in its offer documents, as the day by reference to which the NAV of the Category III AIF is determined. Valuation Day can be set in one or more of the following ways:
    - NAV should be calculated at least once in a calendar month, for open-ended Category III AIFs, or at least once in a quarter for closed-ended Category III AIFs, as on the last Business Day of such calendar month or quarter. In case a Category III AIF is investing in listed securities only, NAV is usually computed on a daily basis.
    - NAV should be calculated on the close of business of the last securities market, on every Business Day, in which the fund deals or executes trades. This is done for the purpose of Mark-to-Market (MTM).
    - NAV can be computed at such intervals, as determined by the Investment Manager, for the purposes of a closing or for redemptions or distributions, as applicable. Each such day is considered as a Valuation Day.

- **Class of Units**: The number of 'Units' issued by a Category III AIF determine the 'Beneficial Interest' of every investor in that fund. Such Beneficial Interest is the basis of making allocation of units or distributions to the investors, on liquidation or redemption.

A Category III AIF may have differential rights assigned to a specific group of investors, or a class of investors, based on quantum of Commitments, the time period for such commitments made by a class of investors and the proportion of such Commitments to the Total Fund Corpus. In order to identify the investors with differential rights, the Category III AIF manager can issue different “Class of Units” to such class of investors. Hence, a Category III AIF can issue a different Class of units, or a category of units, to the Institutional Investors, Sponsor, employees of Investment Manager and other investors with a Beneficial Interest in the Category III AIF.

The categorization of units in different classes is at the discretion of the Investment Manager. One illustration of issuing different Class of units is shown below:

Illustration:

Class A, Class B and Class C units are issued to the investors and divided into various sub-classes depending on the quantum of the Capital Commitment made by such investors, whether individually or in association with other investors including their respective relatives, trust entities or company. The minimum contribution from every investor shall be Rs. 1 crore.

Class D, Class E and Class F units are issued to the Sponsor, employees of the Investment Manager, members of the Investment Management Team and friends, family or relatives of the members of the investment Team.

Class A units can be divided into various sub-classes, depending on the quantum of Management Fees payable, as described below are issued as follows:

Class of Units	Capital Commitment	Management Fee (p.a.)
Class A1 Units	Capital Commitment equal to or more than Rs. 1 crore but less than Rs.5 crore	2.50%
Class A2 Units	Capital Commitment equal to or more than Rs. 5 crore but less than Rs. 10 crore	2.10%
Class A3 Units	Capital Commitment equal to or above Rs. 10 crore	1.75%

Class B units can be divided into various sub-classes, depending on the quantum of Management Fees and Incentive Fees payable, as described below:

Class of Units	Capital Commitment	Management Fee (p.a.)	Incentive Fees
Class B1 Units	Capital Commitment equal to or more than Rs. 1 crore but less than Rs. 5 crore	1.75%	15%
Class B2 Units	Capital Commitment equal to or more than Rs. 5 crore but less than Rs. 10 crore	1.40%	15%
Class B3 Units	Capital Commitment equal to or above Rs. 10 crore	1.10%	15%

Class C units can be divided into various sub-classes, depending on the quantum of Management Fees and Incentive Fees payable, as described below:

Class of Units	Capital Commitment	Management Fee (p.a.)	Incentive Fees
Class C1 Units	Capital Commitment equal to or more than Rs. 1 crore but less than Rs. 10 crore	1.25%	-
Class C2 Units	Capital Commitment equal to or above Rs. 10 crore	1.00%	-
Class C3 Units	Capital Commitment equal to or above Rs. 10 crore	0.75%	15%

Class D Units shall be issued to the Sponsor of the Category III AIF, and/or such person as the Investment Manager may designate on making the Capital Contribution.

Class E Units shall be issued to partners and employees of the Investment Manager and/or employee welfare trust established by the Category III AIF, and/or such person as the Investment Manager may designate on making the Capital Contribution.

Class F Units shall be issued to friends, family or relatives of the members of the investment Team and/or such person as the Investment Manager may designate, and can be divided into various sub-classes, depending on the quantum of Management Fees and Additional Return payable, as described below:

Class of Units	Capital Commitment	Management Fee (p.a.)	Incentive Fees
Class F1 Units	Capital Commitment equal to or more than Rs. 1 crore but less than Rs. 10 crore	1.50%	-

Class F2 Units	Capital Commitment equal to or above Rs. 10 crore	1.25%	-
Class F3 Units	Capital Commitment equal to or above Rs. 10 crore	0.75%	15%

The Investment Manager may cause the Category III AIF to issue further Class of units in the future, which will have the same underlying portfolio but may have varied fee structure as the Investment Manager may decide in its sole discretion.

- **Series**: A Series of a particular Class of units is distinct and exclusive from another series of the same Class of units. In order to identify different class of investors, the Investment Manager may create a series within the same class of units.

  Continuing the previous illustration, in the first close of the Category III AIF, all investors making Capital Commitments of more than Rs. 5 crore and less than Rs. 10 crore can be allocated a distinct Series, but within Class A2 units only.

The Net Asset Value (NAV) for every unit of the Category III AIF is obtained by dividing the net value of the assets attributable to each class/sub-class of units, as reduced by net liabilities, contingencies, losses and expenses attributable to such class/sub-class of units, by the total number of units issued to the unit holders and rounded upto four decimal places. The NAV per unit shall be calculated separately for each class of units or a Series of units.

The Fund's assets comprise the following:

- All cash and bank account holdings, plus earned interest;
- All securities and investments owned by the Fund;
- All dividends and distributions receivable in cash or otherwise
- All interest earned on interest-bearing securities held by the Fund
- All financial rights relating to the use of derivative instruments
- The Fund's provisional expenses where these have not been written off, provided that they can be directly written off against the Fund's capital; and
- All other assets of any kind and composition, including prepaid expenditure.

The Fund's liabilities comprise the following:

- All borrowings and other amounts due
- Tax expense as allocated to the investor's account, in accordance with the Contribution Agreement
- All administrative expenses payable or incurred, including establishment and registration costs payable to registration agents; legal fees; audit fees; fees payable

to the Investment Manager and all other fees, charges, or expenses listed out in the Private Placement Memorandum

- All known liabilities, whether due or not yet due, including dividends declared but not yet paid
- All other liabilities of any kind to third parties

Determination of Total Value of Assets and Liabilities of a Category III AIF:

The assets and liabilities of a Category III AIF are valued in accordance with the Indian Accounting Standards:

- Securities traded on a stock exchange or other regulated markets are to be valued at the closing price quoted on the relevant exchange or market, as on the relevant Valuation Day.

- Unlisted equity securities should be valued initially at cost and thereafter the independent valuer, appointed by the Trustee or the Investment Manager, will value the unquoted investments at Fair Market Value of such securities, as on the relevant Valuation Day.

- Unlisted securities other than equities, for which there is an ascertainable market, valuation will be done at the closing price dealt on the market on which the securities are traded, on the relevant Valuation Day.

  For unlisted securities for which there is no ascertainable market, valuation will be done at amortized cost of such security, plus interest (if any) accrued from the date of such purchase.

- The value of units held in any unit trust, mutual fund, Investment Corporation, or other similar investment vehicle shall be derived from the last prices published by the managers thereof, on the relevant Valuation Day.

- The value of any cash in hand or on deposit, bills and demand notes and accounts receivable, prepaid expenses, cash dividends and interest accrued and not yet received shall be deemed to be the full amount thereof, unless it is unlikely to be paid or received in full.

- Determination of NAV should be done in Indian Rupee (INR). Any investment made in a currency, otherwise than in INR shall be converted into INR at closing market rate, on the relevant Valuation Day.

- The realisation value of futures or options contracts officially listed on a market or traded on a regulated market shall be determined on the basis of the latest available settlement prices of these contracts on the stock exchanges and market on which the Fund trades the contracts.

- The realisation value of futures or options contracts not officially listed on a market or traded on an unregulated market should be the net realisable value as determined by a method determined by the independent valuer.

Let us understand the computation of NAV, with the help of an example:

Example 1:

Fund INC has made investments across different asset classes. On January 01, 2020, the Investment Manager raised Rs. 50 crore, by issuing 5,00,000 units at an NAV of Rs. 1,000 per unit. The assets and liabilities of the fund, as on Valuation Date June 30, 2020, are stated below. Calculate the NAV of the Fund and analyse the investments.

Particulars	Quantity	Rate (Rs.)	Amount (Rs.)
ASSETS:			
Listed Equities:			
Company ABC	50,000	840.00	4,20,00,000.00
Company XYZ	1,00,000	1190.00	11,90,00,000.00
Company PQC	10,00,000	150.00	15,00,00,000.00
Company LMN	75,000	2250.00	16,87,50,000.00
Unlisted Equities (Fair Market Value):			
Company SME	1,50,000	110.00	1,65,00,000.00
Unlisted Debt Investments:			
Corporate Bonds issued by RCE Ltd. Face Value -Rs.10,000, Coupon Rate – 9%	1,000	105.00	10,50,00,000.00
Units in Equity-oriented Mutual Funds:			
Units of Equity Fund - EAMC	10,00,000	23.75	2,37,50,000.00
Cash and Receivables:			
Cash-in-hand			2,50,000.00
Receivable - Dividend Income			50,00,000.00
TOTAL ASSETS			**63,02,50,000.00**
LIABILITIES AND EXPENSES:			
Annual Charges payable to Service Providers			1,50,00,000.00
Tax Liabilities			1,23,50,000.00
Salaries and Administrative Expenses			1,00,00,000.00
Fees Payable - Management Fees			60,00,000.00
Fees Payable - Incentive Fees			1,02,00,000.00
TOTAL LIABILITIES			**5,35,50,000.00**
No. of Units issued			5,00,000

Solution:

$$NAV = \frac{\text{Total Assets – Total Liabilities}}{\text{No. of Units Issued}}$$

$$NAV = \frac{\text{Rs. 63,02,50,000 – Rs. 5,35,50,000}}{\text{5,00,000}}$$

$$NAV = \frac{\text{Rs. 57,67,00,000}}{\text{5,00,000}}$$

NAV = Rs. 1153.40

Conclusion:

- Listed Equities are valued based on the closing prices of the stocks, as on June 30, 2020, on a recognized stock exchange.

- Unlisted Investment in Company SME is taken based on the Fair Market Value, derived from the valuation done by the independent Registered Valuer appointed by the Fund.

- Unlisted investment in debt securities is done based on the 'Amortized Cost' of the bond. Amortized Cost is derived by taking the purchase cost, after adjusting the discount/premium on purchase of such bond, throughout the maturity period of the bond. Assuming no interest is accrued from the date of purchase of the bond, valuation is done at the Amortized Cost without adding any interest income.

- Investment in Fund EAMC is based on the NAV of the fund published by the Investment Manager, as on June 30, 2020.

- Cash-in-hand and Dividend Receivable is taken as per actuals. Dividend declared but not received is an asset for the fund, and eventually an income.

- Liabilities are taken as declared by the Fund. Expenses incurred on behalf of the fund, such as Fees payable to the Investment Manager, salaries, administrative expenses and annual charges payable to Service Providers are also taken into account for computing the NAV.

- The NAV as increased from Rs. 1,000, as on January 01, 2020 to Rs. 1153.40 as on June 30, 2020.

- The NAV calculation is done based on the information provided in the Statement of Assets and Liabilities. Any contingent liabilities accruing to the fund, such as potential market risks, legal suits and foreign exchange movements can also be taken into consideration.

Mark-to-Market

Mark-to-Market is the process of valuing the Category III AIF portfolio, based on the fair market value of every security i.e. marking the securities to the market value, on a periodical basis. The Fair Market Value of all securities is determined on every Valuation Day and the NAV is accordingly revised to represent the 'true-worth' of the fund portfolio, as on that day. The Marked-to-Market NAV is disclosed to investors on a periodical basis, to determine the return earned on investments. Unless Mark-to-Market process is done on a periodical basis, the fund portfolio will continue to be valued at the Cost at which the security was bought, especially when valuing unlisted securities.

Incentive Fees payable to the Investment Manager is based on the return earned by the Category III AIF, using current market prices. Mark-to-Market process is crucial for the Investment Manager and investors, to determine the fair amount of Incentive Fees payable, as on a particular Valuation Day. Further, Mark-to-Market ensures fair practice in redemption or withdrawal of units of a Category III AIF scheme. The price at which an investor shall redeem or withdraw the scheme units will be determined by the Marked-to-Market NAV. Since Category III AIFs invest in derivative contracts, it becomes essential for the Investment Manager to follow Daily Mark-to-Market process, for reconciliation of margin accounts with brokers and representing a Fair Value of the Portfolio.

Let us continue with our example of Fund INC and ascertain the importance of Mark-to-Market.

Example 2:

Fund INC has made investments across different asset classes. On January 01, 2020, the Investment Manager raised Rs. 50 crore, by issuing 5,00,000 units at an NAV of Rs. 1,000 per unit. The assets and liabilities of the fund, as on Valuation Date July 31, 2020, are stated below. Calculate the NAV of the Fund and analyse the investments.

Particulars	Quantity	Rate (Rs.)	Amount (Rs.)
ASSETS:			
Listed Equities:			
Company ABC	50,000	950.00	4,75,00,000.00
Company XYZ	1,00,000	1340.00	13,40,00,000.00
Company PQC	9,00,000	165.00	14,85,00,000.00
Company LMN	75,000	2650.00	19,87,50,000.00
Unlisted Equities (Fair Market Value):			
Company SME	75,000	165.00	1,23,75,000.00
Unlisted Debt Investments:			
Corporate Bonds issued by RCE Ltd. Face Value -Rs. 10,000, Coupon Rate – 9%	1,000	105.20	10,52,00,000.00
Units in Equity-oriented Mutual Funds:			
Units of Equity Fund - EAMC	5,00,000	25.40	1,27,00,000.00
Units of Equity Fund - MAMC	10,00,000	13.20	1,32,00,000.00

Particulars	Quantity	Rate (Rs.)	Amount (Rs.)
Cash and Receivables:			
Cash-in-hand			75,000.00
TOTAL ASSETS			**67,23,00,000.00**
LIABILITIES AND EXPENSES:			
Annual Charges payable to Service Providers			1,00,00,000.00
Tax Payable – GST on Management Fees			1,08,000.00
Salaries and Administrative Expenses			1,00,00,000.00
Provision – Capital Gains Tax			15,00,000.00
Fees Payable – Incentive Fees			1,62,00,000.00
TOTAL LIABILITIES			**3,78,08,000.00**
No. of Units issued			5,00,000

Solution:

$$NAV = \frac{\text{Total Assets – Total Liabilities}}{\text{No. of Units Issued}}$$

$$NAV = \frac{\text{Rs. } 67{,}23{,}00{,}000 - \text{Rs. } 3{,}78{,}08{,}000}{5{,}00{,}000}$$

$$NAV = \frac{\text{Rs. } 63{,}44{,}92{,}000}{5{,}00{,}000}$$

NAV = Rs. 1268.9840

Conclusion:

- Listed Equities are valued based on the closing prices of the stocks, as on July 31, 2020, on a recognized stock exchange. Unlisted Investment in Company SME is taken based on the Fair Market Value, derived from the valuation done by the independent Registered Valuer appointed by the Fund.

- It is observed that the Fund has sold part holding in unlisted shares of Company SME and listed shares of Company PQC. Market Prices of other companies have increased in the last month, which resulted in the increase of NAV, as on July 31, 2020.

- Unlisted investment in debt securities is done based on the Amortized Cost of the bond. The Market Price of such bonds can be derived from OTC debt market trades.

- Investment in Fund EAMC is based on the NAV of the fund published by the Investment Manager, as on July 31, 2020. The Fund INC has sold part of the holding in Fund EAMC and invested the proceeds in Fund MAMC.

- Previous Liabilities of the Fund are paid from dividends receivables and sale proceeds from equity shares. Liabilities of management fees and tax liabilities are paid-off. Additional liabilities in the current month, of GST and Capital Gain Tax provision, have been taken into account to compute the NAV.

- The NAV has increased substantially and Marked-to-Market with the market values, as on July 31, 2020. This valuation is based on Fair Market Prices and makes a good proposition for payment of Incentive Fees to the Investment Manager.

8.2 Valuation Techniques

As seen in the previous topic, a Category III AIF can invest across multiple asset classes such as Equities, Mutual Funds, Fixed Income Securities and Derivatives. Investments may be made by the Category III AIF in liquid securities as well as illiquid securities. All these asset classes have distinct features and therefore require the Category III AIF to use different techniques to value the NAV based on the underlying asset class in the portfolio.

8.2.1 Portfolio of Liquid and Illiquid Securities

Liquid securities have a ready market for trades, with a large number of buyers and sellers and have a large volume of trades executed, on a daily basis, by the market participants. Therefore, such securities are redeemable at the Fair Market Value (FMV), as on a specific Valuation Day. On the contrary, the market for illiquid securities has a small number of buyers and sellers for trade execution and has a relatively small volume of trades executed, on a daily basis. The investments in illiquid securities may not be redeemable at its Fair Market Value, as on a specific Valuation Day.

The valuation methods to be used for computing the Fair Market Value of liquid securities shall be clearly stated in the Valuation Policy of the Category III AIF. Liquid Securities can be valued using the methods discussed above, by taking the fair market value of listed equities, mutual fund units, exchange-traded derivatives and fixed income securities.

However, valuation of illiquid securities shall not be done on the basis of the Fair Market Value of the security. The Investment Manager shall clearly state the Valuation Method adopted by the fund for the valuation of illiquid securities, approved by an independent registered valuer. One such method of valuing illiquid securities is discounting the future Fair Market Value of an illiquid security. An illiquid security, such as stocks of an SME or thinly-traded company, have a relatively small trading volume due to which the Investment Manager of a Category III AIF may not be able to redeem all the holdings in one trade or deal. This impacts the future fair market value, or net redeemable price of such illiquid securities. Based on the total holding of such illiquid securities and the daily trading volume, the manager should ascertain the future impact on stock price and the net proceeds on redemption, thereon.

Let us understand an example of Valuation of an Illiquid Security, with the help of the following example.

Example 3:

Fund ILS has made investment of Rs. 50 lakhs in Company ASME. Using the data provided as on T-day (Valuation Day), ascertain the Fair Market Value to be taken, for the purpose of valuing the stock:

Particulars	**Amount**
Total Shares purchased in Company ASME	2,00,000
Total Outstanding Shares in Company ASME	1,00,00,000
Face Value	Re. 1.00
Market Price (FMV on T-day)	Rs. 25/share
Daily Trading Volume (in shares)	50,000
Daily Price Band	+/- 2%
Cost of Capital (Opportunity Cost for Fund)	12% p.a.

Solution:

Current Market Price of one share of Company ASME is Rs. 25, being traded on an SME Exchange. However, for the purpose of computing NAV of Fund ILS, the Fair Market Value of Rs. 25 should not be taken, due to the illiquidity in the market and lower trading volume of the stock.

Total Shares Held by Fund ILS = **2,00,000 shares**
(Corresponding to a 2% holding in Company ASME)

Daily Trading Volume = **50000 shares**

If Fund ILS would want to sell all shares in Company ASME, it would take minimum 4 trading days for the Fund to execute "SELL" orders for the entire holding. (200000 shares / 50000 shares)

Hence, the Sale Price for all 2,00,000 shares executed on four trading days would be as follows, assuming the Lower Price Band for the share due to Large Sale:

Particulars	**T Day**	**T+1 Day**	**T+2 Day**	**T+3 Day**
Number of shares sold	50,000	50,000	50,000	50,000
Market Price (Rs.)	25.00	24.50	24.01	23.53
Net Proceeds	**12,50,000**	**12,25,000**	**12,00,500**	**11,76,500**
Present Value of Net Proceeds as on T-Day (Valuation Day)	12,50,000	12,24,412	11,99,348	11,74,807

Total PV of Net Proceeds = **Rs.48,48,568**
Total Shares held by Fund ILS = **Rs.2,00,000**

Fair Value of Share of Company ASME =**Rs. 24.2428 per share**

It can be observed that the Fair Market Value of shares of Company ASME has reduced substantially from Rs. 25 per share to Rs. 24.2428 per share. The valuation of shares has dropped by more than 3%. This is primarily due to inherent illiquidity and the subsequent fall in prices of the securities. If the Fund executes SELL trades in four continuous days, then Net Proceeds from the shares will be affected due to drop in price of the shares.

Note:

- Market Price of the stock has been computed by reducing 2% from the previous day's closing price. This is under the assumption that the stock has hit its lower price band for one trading day, with no further trades on the specific trading day.
- Net Proceeds for each trading day is computed, assuming that Fund ILS has been able to successfully place SELL orders for all 50000 shares in one single trading day.
- It is necessary to compute the present value of the net proceeds from the trades, to be received on T+1 day, T+2 day and T+3 day, as the Valuation Day taken in our example is T-day.
- For the purpose of computing Present Value of Net Proceeds, the discounting factor is computed for one trading day, by taking the Opportunity Cost of capital of 0.048% per day, i.e. 12% per annum, and assuming 250 trading days in a year.

8.2.2 Positions in Commodity Derivatives and Equity Derivatives Markets

A Category III AIF is permitted to trade in Equity Derivatives contracts and Commodity Derivatives contracts, such as Commodity Futures and Commodity Options, up to a prescribed limit of 10 percent of its investable funds in one underlying commodity.[130] Commodity Futures are available on recognized stock exchanges, with standard contract terms, lot sizes, prices and expiry date. Commodity options are available for trade on recognized stock exchanges, as a second-order derivative contract with commodity futures as its underlying asset.

A Category III AIF can enter into a Futures contract to buy or sell an underlying asset, at a future date, at a pre-determined price. In a futures contract, the fund has the obligation to buy or sell the contract, for final physical settlement, at the pre-specified date and pre-specified price. A buy position or a "Long Position" states that the fund will purchase the underlying asset, at the pre-specified date and pre-specified price, indicating that the investment manager estimates the price of the underlying asset to increase in future. Similarly, sell position or a "Short Position" states that the fund will sell the underlying asset, at the pre-specified date and pre-specified price, indicating that the manager estimates the price of the underlying asset to decrease in future. A Category III AIF can deal in:

- "Stock Futures", wherein the underlying asset is a stock of a specific company.
- "Index Futures", wherein the underlying asset is an Equity-based Index.

[130] SEBI Circular No.: SEBI/HO/CDMRD/DMP/CIR/P/2017/61 dated June 21, 2017 on Participation of Category III Alternative Investment Funds (AIFs) in the commodity derivatives market.

- “Commodity Futures”, wherein the underlying asset is a single commodity product such as Precious Metals, Base Metals, Energy Products or Agricultural Products.

Like a Futures Contract, a Category III AIF can enter into an Options contract, wherein the fund has a right but no obligation to buy or sell an underlying asset, at a future date, at a pre-determined price. Buying a “Call option” is similar to taking a Long position in Futures; however the Investment Manager will not have the obligation to “buy” the underlying asset at expiry of the contract. Similarly, buying a “Put Option” is similar to taking a Short position in Futures; however the Investment Manager will not have the obligation to “sell” the underlying asset at expiry of the contract. A Category III AIF can deal in:

- “Stock Options”, wherein the underlying asset is a stock of a specific company.
- “Index Options”, wherein the underlying asset is an Equity-based Index.
- “Commodity Options”, wherein the underlying is the right to enter into a Commodity Futures contract, having the same underlying commodity asset as the Option contract.

As already discussed in section 5.6.3 of Unit 5, a Category III AIF may take Leverage through investments in derivative contracts, provided:

- Prior consent of investors in the fund is taken
- Maximum Leverage should be2 times of the Net Asset Value (NAV) of the Fund.
- Disclosures are made to investors and SEBI periodically.

For the purpose of limiting Leverage taken by the Fund, SEBI has laid the ratio to compute the maximum permissible Leverage by the Fund, as under:

$$\text{Leverage} = \frac{\text{Total exposure \{Long positions + Short positions (after offsetting as permitted)\}}}{\text{Net Asset Value (NAV)}}$$

- Total exposure will be calculated as the sum of the market value of the long and short positions of all securities / contracts held by the fund;
- Idle cash and cash equivalents are excluded while calculating exposure;
- Temporary borrowing arrangements which relate to and are fully covered by capital commitments from investors are excluded from the calculation of leverage;
- Offsetting of positions shall be allowed for calculation of leverage in accordance with the SEBI norms for hedging and portfolio rebalancing;
- Category III AIFs investing in units of other AIFs may undertake leverage not exceeding two times the NAV, which excludes the value of investment in units of other AIFs.[131]

Valuation of Derivative positions is done by computing the **“Total Exposure”** with the following:

[131] As per SEBI Circular No. SEBI/HO/IMD-I/DF6/P/CIR/2021/584 dated June 25, 2021

- **Exposure in Futures Contracts:** On date of entering into a futures contract (T-day), the Futures Price at which a Category III AIF enters into a contract and the number of contracts entered into is taken for the purpose of computing Total Exposure. For all subsequent Valuation Days, mark-to-market process is followed to represent the Fair Market Value of the underlying asset, in the Futures Contract.
- **Exposure in Options Contracts:** On date of entering into an options contract (T-day), the Total Exposure is computed as the Option Premium paid for entering into the Option Contract. For all subsequent Valuation Days, Black-Scholes Model and the mark-to-market process is followed for pricing the Options contract at Fair Market Value.

  As per the Black-Scholes Model, the price of the Option, i.e. the Option Premium, is calculated based on the underlying asset price, exercise price, inherent volatility in asset price, changes in interest rates and time period to Option Expiry. A change in the Option Premium indicates the change in the probability of the option being in-the-money[132], or generating a profit, at expiry.

- **Margin:** For entering into a derivative contract, the Category III AIF will need to deposit the required applicable margins (SPAN Margin, Exposure Margin, VaR Margin, Extreme Loss Margin, Initial Margin and Mark-to-Market Margin) with the respective broker and central counter-party. Such deposits with brokers are taken as an "Asset" for the purpose of computing the NAV of a Category III AIF. Any changes in the underlying prices of futures and options contracts will impact the margin accounts, i.e. a loss on F&O activity will result in additional "Liability" towards the margin and a profit on F&O activity will result in an increase in the balance of the margin accounts, hence an "Asset".

- **Calculation of Total Exposure:** Total Exposure of the Fund is computed by adding the exposure in all long positions, i.e. Long Futures and Call Options, and exposure in short positions, i.e. Short Futures and Put Options. If a Category III AIF has taken a long position as well as taken short position in the same stock, index or commodity, with the same maturity period, such positions can be offset with each other to compute the net exposure towards the single stock, index or commodity.

- **NAV and Leverage:** The maximum exposure permitted towards derivative contracts is 2 times the NAV of the Category III AIF. The Investment Manager should be responsible to maintain the required Leverage Limits and ensure that Total Exposure towards derivatives, after offsetting positions, does not surpass twice the amount of the NAV. Moreover, during the mark-to-market process, the Investment Manager should ensure that total exposure does not breach the Leverage Limits, due to an increase/decrease in the price of the underlying asset.

[132] 'Moneyness' refers to the intrinsic value of an option, based on the current futures contract price of the underlying asset, as on one trading day. A call option is "in-the-money" when the future contract price is above the strike price. Similarly, the call option is "out-of-the-money" when the future contract price is below the strike price. A call option is "at-the-money" when the future contract price is equal to the strike price.

Let us understand valuation of Derivatives and mark-to-market process with the example of Fund INC being continued:

Example 4:

Fund INC has made investments across different asset classes. On January 01, 2020, the Investment Manager raised Rs. 50 crore, by issuing 5,00,000 units at an NAV of Rs. 1,000 per unit.

The assets and liabilities of the fund, as on Valuation Date May 15, 2020, are stated below.

Particulars	Quantity	Rate (Rs.)	Amount (Rs.)
ASSETS:			
Listed Equities:			
Company ABC	50,000	825.00	4,12,50,000.00
Company PQC	10,00,000	145.00	14,50,00,000.00
Company LMN	75,000	2250.00	16,87,50,000.00
Unlisted Equities (Fair Market Value):			
Company SME	1,50,000	115.00	1,72,50,000.00
Unlisted Debt Investments:			
Corporate Bonds issued by RCE Ltd. Face Value -Rs. 10,000, Coupon Rate – 9%	1,000	105.00	10,50,00,000.00
Units in Equity-oriented Mutual Funds:			
Units of Equity Fund - EAMC	10,00,000	23.75	2,37,50,000.00
Cash and Receivables:			
Cash-in-hand			2,50,000.00
Receivable - Dividend Income			50,00,000.00
Balance with Brokers –F&O Margin Account			11,00,00,000.00
TOTAL ASSETS (A)			**61,62,50,000.00**
LIABILITIES AND EXPENSES:			
Annual Charges payable to Service Providers			1,50,00,000.00
Tax Liabilities			1,23,50,000.00
Salaries and Administrative Expenses			1,00,00,000.00
Fees Payable - Management Fees			60,00,000.00
Fees Payable - Incentive Fees			1,02,00,000.00
TOTAL LIABILITIES (B)			**5,35,50,000.00**
No. of Units issued (C)			5,00,000
NAV (Rs.) (A-B)/C			**1125.40**

As on May 16, 2020, the Investment Manager has made an investment decision to invest in Equity Derivatives and Commodity Derivatives. Consequently, the Fund has taken the following Long positions and Short positions in Derivatives, at the opening hours on May 16, 2020:

Trades executed on May 16, 2020 at 9:15:15 AM

Index Options: Bought

Particulars	No. of Lots	Lot-size	Premium (Rs.)	Notional Exposure (Rs.)	Total Premium (Rs.)
Nifty 9000 - PE Exp - 25JUN2020	300	75	380	85,50,000	85,50,000
Nifty 9700 - CE Exp - 25JUN2020	600	75	110	49,50,000	49,50,000

Futures Contracts in Stocks and Commodities – Short Positions

Particulars	No. of Lots	Lot-size	Futures Price (Rs.)	Notional Exposure (Rs.)	Total Margin (Rs.)
Investment LMN Exp - 25JUN2020	300	250	2275	17,06,25,000	5,49,15,900
Gold Futures Exp– 5AUG2020	50	100 (1000 gm)	47,550	23,77,50,000	1,57,78,800

Calculate the Total Exposure and Total Leverage of Fund INC and verify if the Fund adheres to the Leverage Limits.

Solution:

Fund INC has taken both long position, i.e. a "Call Option", and a short position, i.e. a "Put Option" in NIFTY Options. Option Premium to be paid is an expense for the Fund, as the Option grants the Fund a right but not an obligation to exercise the option on expiry. However, a Long Position in Futures contracts is taken only after paying the Initial Margin, applicable to Equity Derivatives and Commodity Derivatives. Margin paid on Futures is subject to Mark-to-Market process on a daily basis and balance in the margin account varies based on changes in the value of the underlying asset.

Total Premium payable to the broker for NIFTY Options is Rs. 1,35,00,000 and the Total Margin payable to the broker for Futures in Gold and Futures in Investment LMN is Rs. 7,06,94,700.

Total Exposure to Derivatives Contracts is the total of Notional Exposure for all futures contracts and option contracts:

Derivative Contract	Type	Notional Exposure (Rs.)
NIFTY50	Put Options	85,50,000
NIFTY50	Call Options	49,50,000
Net Exposure in NIFTY Options (After Off-setting) [A]		**36,00,000**
Stock Futures – LMN	Long Futures	17,06,25,000
Net Exposure in Stock Futures [B]		**17,06,25,000**
Commodity Futures – Gold	Long Futures	23,77,50,000
Net Exposure in Commodity Futures [C]		**23,77,50,000**
	Total Exposure [A + B + C]	**41,19,75,000**

In order to compute the Total Leverage of the Fund, we compute the revised NAV, on account of the transactions done in derivatives:

NAV Computation – May 16, 2020at 9:20:00 AM

Particulars	Quantity	Rate (Rs.)	Amount (Rs.)
ASSETS:			
Listed Equities:			
Company ABC	50,000	825.00	4,12,50,000.00
Company PQC	10,00,000	145.00	14,50,00,000.00
Company LMN	75,000	2250.00	16,87,50,000.00
Unlisted Equities (Fair Market Value):			
Company SME	1,50,000	115.00	1,72,50,000.00
Unlisted Debt Investments:			
Corporate Bonds issued by RCE Ltd. Face Value -Rs. 10,000, Coupon Rate – 9%	1,000	105.00	10,50,00,000.00
Units in Equity-oriented Mutual Funds:			
Units of Equity Fund - EAMC	10,00,000	23.75	2,37,50,000.00
Cash and Receivables:			
Cash-in-hand			2,50,000.00
Receivable - Dividend Income			50,00,000.00
Balance with Brokers – F&O Margin Account (refer Notes below)			2,58,05,300.00

Particulars	Quantity	Rate (Rs.)	Amount (Rs.)
TOTAL ASSETS			**53,20,55,300.00**
LIABILITIES AND EXPENSES:			
Annual Charges payable to Service Providers			1,50,00,000.00
Tax Liabilities			1,23,50,000.00
Salaries and Administrative Expenses			1,00,00,000.00
Fees Payable - Management Fees			60,00,000.00
Fees Payable - Incentive Fees			1,02,00,000.00
TOTAL LIABILITIES			**5,35,50,000.00**
No. of Units issued			5,00,000
NAV (Rs.)			**957.0106**

Revised Net Asset of the Fund = Rs. 47,85,05,300.00 (i.e. Rs. 53,20,55,300 – Rs. 5,35,50,000)
Total Exposure to Derivatives = Rs. 41,19,75,000.00

Leverage = $\frac{\text{Rs. 41,19,75,000}}{\text{Rs.47,85,05,300.00}}$

Leverage = 0.86

Notes:

- The Leverage Ratio is within the limit of 2.00. This is also due to the benefit of off-setting positions taken in NIFTY50 Options, as the contracts have the same expiry.
- Opposite positions are taken in NIFTY50 options, but with different exercise prices. This is majorly done to hedge the risk of NIFTY index going below the levels of 9000 and also gain from upward movements in NIFTY, above the levels of 9700.
- A significant drop in the NAV is observed, primarily on account of payment of margin for the futures contracts and the option premium on NIFTY50 Options. The Balance maintained with Brokers in the F&O Margin Account will reduce, as follows:

Particulars	Amount (Rs.)
Opening Balance as on May 16, 2020	11,00,00,000.00
Less: Margin payable for Gold Futures	(1,57,78,800.00)
Less: Margin payable for Stock LMN Futures	(5,49,15,900.00)
Less: Total Option Premium on NIFTY50 Options	(1,35,00,000.00)
Balance as on May 16, 2020 at 09:20 AM	**2,58,05,300.00**

- Practically, derivative trades are not executed by the broker, till the Margin Money is deposited by the investment manager, in the Margin Account maintained with the broker. As is evident from the example, Fund INC is maintaining sufficient balance in the F&O Margin Account maintained with the broker, in order to execute the trade.

Mark-to-market of Derivatives:

Mark-to-Market is the process of valuing the Category III AIF portfolio, based on the fair market value of every security i.e. marking the securities to the market value, on a periodical basis. The same process is followed for derivative contracts. Option contracts are exercised at the Expiry of the contract. However, changes in the value of the futures contract are marked-to-market on a daily basis, to check for daily profit or loss and adjust the balance in the margin account, accordingly.

Let us continue the previous example of Fund INC to compute the Mark-to-Market profit or gain and the consequent NAV.

Example 5:

Fund INC had bought the following contracts on May 16, 2020 at 9:15:15 AM

Index Options: Bought

Particulars	No. of Lots	Lot-size	Premium (Rs.)	Notional Exposure (Rs.)	Total Premium (Rs.)
Nifty 9000 - PE Exp - 25JUN2020	300	75	380	85,50,000	85,50,000
Nifty 9700 - CE Exp - 25JUN2020	600	75	110	49,50,000	49,50,000

Futures Contracts in Stocks and Commodities – Short Positions

Particulars	No. of Lots	Lot-size	Futures Price (Rs.)	Notional Exposure (Rs.)	Total Margin (Rs.)
Investment LMN Exp - 25JUN2020	300	250	2275	17,06,25,000	5,49,15,900
Gold Futures Exp– 5AUG2020	50	100 (1000 gm)	47550	23,77,50,000	1,57,78,800

Closing Futures Prices of underlying assets, as on May 16, 2020 at 04:00:00 PM are given below:

Particulars	Futures Price (Rs.)
Investment LMN Exp - 25JUN2020	2150.00
Gold Futures Exp– 5AUG2020	46760.00

Compute the Mark-to-Market Profit/Loss and NAV as on May 16, 2020, assuming the following closing prices of other investments:

Particulars	Closing Price (Rs.)
Company ABC	865.00
Company PQC	165.00
Company LMN	2145.00
Company SME	125.00
Corporate Bonds issued by RCE Ltd.	105.00
Units of Equity Fund - EAMC	23.78

Solution:

Computation of Mark-to-Market Profit on Short Positions – as on May 16, 2020

Particulars (1)	No. of Lots (2)	Lot-size (3)	Futures Price (Rs.) at 4:00 PM (4)	Futures Price (Rs.) at 9:15:15 AM (5)	Unrealized Profit/(Loss) (6) [(5)-(4)]*(2)*(3)
Investment LMN Exp - 25JUN2020	300	250	2150.00	2275.00	93,75,000
Gold Futures Exp– 5AUG2020	50	100 (1000 gm)	46760.00	47550.00	39,50,000
				Total	**1,33,25,000**

Computation of MTM NAV – as on May 16, 2020

Particulars	Quantity	Rate (Rs.)	Amount (Rs.)
ASSETS:			
Listed Equities:			
Company ABC	50,000	865.00	4,32,50,000.00
Company PQC	10,00,000	165.00	16,50,00,000.00
Company LMN	75,000	2145.00	16,08,75,000.00
Unlisted Equities (Fair Market Value):			
Company SME	1,50,000	125.00	1,87,50,000.00
Unlisted Debt Investments:			
Corporate Bonds issued by RCE Ltd. Face Value -Rs. 10,000, Coupon Rate – 9%	1,000	105.00	10,50,00,000.00
Units in Equity-oriented Mutual Funds:			

Units of Equity Fund - EAMC	10,00,000	23.78	2,37,80,000.00
Cash and Receivables:			
Balance with Brokers – F&O Margin Account			3,91,30,300.00
Cash-in-hand			2,50,000.00
Receivable - Dividend Income			50,00,000.00
TOTAL ASSETS			**56,10,35,300.00**
LIABILITIES AND EXPENSES:			
Annual Charges payable to Service Providers			1,50,00,000.00
Tax Liabilities			1,23,50,000.00
Salaries and Administrative Expenses			1,00,00,000.00
Fees Payable - Management Fees			60,00,000.00
Fees Payable - Incentive Fees			1,02,00,000.00
TOTAL LIABILITIES			**5,35,50,000.00**
No. of Units issued			5,00,000
NAV			**1014.9706**

Notes:

- The NAV has increased from Rs. 957.0106 to Rs. 1014.9706, as on closing hours of May 16, 2020, on account of Mark-to-Market Gains on the Derivatives Positions being added to the F&O Margin Account maintained with the Broker, as under:

Particulars	Amount (Rs.)
Balance as on May 16, 2020 at 09:20 AM	2,58,05,300.00
Add: Mark-to-Market Profit in Gold Futures	39,50,000.00
Add: Mark-to-Market Profit in Stock Futures	93,75,000.00
Closing Balance as on May 16, 2020 at 04:00 PM	**3,91,30,300.00**

- The Investment Manager of Fund INC was able to take suitable derivative positions, both in Stock LMN and in Gold. From the portfolio of Fund INC, only Stock LMN has decreased. This may have been done in order to hedge the market risk in Stock LMN.

- It should be noted that NAV is not at the same level, as on opening hours of May 16, 2020. This is because the Investment Manager has taken an off-balance sheet exposure[133] in derivative contracts, which reduces the balance maintained in F&O Margin Account with the broker.

[133] Off-Balance Sheet exposure refers to investing in assets which do not represent a direct obligation on the fund, through leverage strategies and derivative contracts, although risks and returns associated with such assets are indirectly borne by the fund.

8.2.3 Positions in Money Market Instruments and Long Term Fixed Income Securities

The Money Market Instruments consist of instruments such as Treasury Bills (T-bills), Certificates of Deposits (CDs), Commercial Papers (CPs), Bills of Exchange etc. with a short tenor, i.e. not exceeding one year from date of issue. Within the one year, depending upon the tenors, money market is classified into:

- Overnight market - The tenor of transactions is one working day.
- Notice money market – The tenor of the transactions is from 2 days to 14 days.
- Term money market – The tenor of the transactions is from 15 days to one year.

Category III AIFs invest in money market instruments and marketable securities, such as T-bills in order to earn interest on its surplus investable funds that would be invested in securities at a future date. Interest from money market securities may form a substantial part of the interest income for the fund, on account of the high value of transactions executed by such funds and other financial institutions like Banks, Mutual Funds, Insurance Companies and Pension Funds.

A Category III AIF may invest in traded debt securities, or non-traded debt securities. A debt security is considered as a traded debt security when, on a specific Valuation Day, there are trades reported (in marketable lots) in that security on a recognised stock exchange or the Clearing Corporation of India Ltd. (CCIL).

Money market instruments held by Category III AIFs are valued using Mark-to-Market process, with the average of security level prices of such instruments disclosed by Financial Benchmarks India Pvt. Ltd. (FBIL), Clearing Corporation of India Ltd. (CCIL), Fixed Income Money Market and Derivatives Association of India (FIMMDA) and similar valuation agencies. Similarly, valuation of debt instruments for long-term fixed income securities, such as Government Securities (G-Secs) and Corporate Bonds are done using the Mark-to-Market process. The price of all G-Secs, with different maturities is published by the FBIL, CCIL and FIMMDA. Closing prices of the Corporate Debt traded on a Recognized Stock Exchange is used for the purpose of computing the Fair Value of a Corporate Debt Security held by the Category III AIF.

Valuation of T-bills and G-Secs are done using the Volume Weighted Average Yield (VWAY) for trades in the last one hour of trading. Valuation of all other money market and debt securities (including Government securities not traded in last one hour) are done on the basis of VWAY of all trades during the day. Using the Mark-to-Market approach for valuation reduces the potential default risk inherent in a fixed income security, due to a downgrade in the credit rating of a specific security. Instead of using “Amortized Cost” approach of valuation, mark-to-market method is more reliable and transparent, although it may reduce the discretion of managers in the valuation process of debt instruments.

8.3 Computation of NAV for a Category III AIF vs. NAV attributable to a series of units issued to investors

The Net Asset Value (NAV) for every unit of the Category III AIF is obtained by dividing the value of the assets attributable to each class/sub-class of units, as reduced by liabilities, contingencies, losses and expenses attributable to such class/sub-class of units, by the total number of units issued to the unit holders. NAV is rounded upto four decimal places.

The NAV per unit shall be calculated separately for each class of units or a Series of Units. Total Net Assets of the fund represents the total value attributable to all class of units and investors with the Category III AIF. However, it is possible that all classes of units or investors in the Fund may not derive the same Net Asset Value (NAV) for their respective units in the fund. This may be possible on account of differential terms of subscription and fee structure offered to a specific class of units or series of units, based on the quantum of capital commitments made by such investors and the time period when such capital commitments are made.

The Investment Manager of the Category III AIF allocates a unique number to each series of units, within a particular class of units, for the purpose of identification of differential rights offered to such investors and calculation of their applicable "Series NAV".

Series NAV is the NAV of each series of units within a particular class of units allotted to investors and shall be equal to Series Assets, as reduced by the Series Liabilities and Series Expenses, as on a Valuation Day and divided by the number of units issued under such Series. Series NAV is rounded upto four decimal places.

The terms Series Assets, Series Liabilities and Series Expenses are described as under:

Series Assets:

Assets of the Category III AIF which are attributable to a particular Series of units and shall be allocated in the books of the Fund, to that specific Series of Beneficiaries or investors as assets of that Series, as on the Valuation Day. Computation of Series Assets, as on a Valuation Day is done in the following manner:

$$\text{Series Assets} = \frac{\text{Total Assets of Fund} \quad * \quad \text{Opening Series NAV}}{\text{Total of all Opening Series NAV in Fund}}$$

The Opening Series NAV is the Series NAV as on a Valuation Day, immediately prior to the current Valuation Day. On the issue of any new series of units, the Opening Series NAV for such series of units on the first Valuation Day is equal to the amount drawn down against issuance of units of such Series. NAV per unit of each Series of units, as on a Valuation Day, is computed as its Series NAV divided by the number of units issued in such Series.

Series Liabilities:

Liabilities and obligations of the Fund, outstanding as on the Valuation Day, are allocated amongst all Series of units in proportion to the Opening Series NAV.

Series Expenses:

Expenses in relation to each Series shall generally comprise of fund expenses as determined by the differential rights offered to the specific series of units, or Series Beneficiaries.

- Management Fees (including goods and service tax thereon) and Incentive Fees attributable to the specific series of units, as per the Contribution Agreement, shall be charged as Series Expenses.

- Fund Expenses (including goods and service tax thereon) that are specifically attributable to a series of units, shall be borne only by that Series of Beneficiaries, and shall accordingly be allocated in the books of the Fund to that series of units.

- Fund Expenses (including goods and service tax thereon) that are not specifically attributable to a specific series of units shall generally be allocated amongst all the series and class of units, in proportion to the Opening Series NAV of each series issued by the Fund.

The NAV per Unit of each series of units as of a Valuation Day (**NAV per Unit**) shall be the Series NAV of such series of units. Let us understand the calculation of Series NAV through an example:

Example 6:

Fund SER has raised capital commitments worth Rs. 50 crore, by issuing the following Series of Units to investors:

Class of Units/ Series of Units	**No. of Units**	**Issue Price (Rs.)**	**Commitment (Rs.)**
Class A1 Units: Series A1001 – A1020	2,00,000	1000.00	20,00,00,000
Class A2 Units: Series A2001 – A2010	1,00,000	1000.00	10,00,00,000
Class B1 Units: Series B1001 – B1015	1,50,000	1000.00	15,00,00,000
Class C1 Units: Series C1001 – C1005	50,000	1000.00	5,00,00,000
Total	**5,00,000**		**50,00,00,000**

Class C1 units are issued to the Sponsor of Fund SER, as minimum capital contribution of the Sponsor. The Investment Manager has provided a differential right to the investors in Class A1 units, as follows:

Class of Units/Series of Units	Management Fee %
Class A1 Units: Series A1001 – A1020	1.50%
Class A2 Units: Series A2001 – A2010	2.00%
Class B1 Units: Series B1001 – B1015	2.00%
Class C1 Units: Series C1001 – C1005	2.00%

All other Fund Assets, Fund Liabilities and Expenses are charged to every series of units based on the pro-rata Series NAV.

Following data shows the Assets, Liabilities, Expenses and NAV of the Fund, in Year 1 and Year 2 of the fund operations:

Particulars	Year 1 Amount (Rs.)	Year 2 Amount (Rs.)
Total Assets	67,60,00,000.00	79,80,00,000.00
Total Liabilities	3,00,00,000.00	3,50,00,000.00
Fund Expenses:		
1. Yearly Fund Expenses	30,00,000.00	30,00,000.00
2. Set-up Costs	50,00,000.00	-
3. Management Fees	1,37,21,040.00	1,61,99,367.00
Net Assets	**62,42,78,960.00**	**74,38,00,633.00**
No. of Units Issued	5,00,000.00	5,00,000.00
NAV	**1248.5579**	**1487.6013**

Compute the Series NAV per unit, for all four Series and interpret the results.

Solution:

Computation of Management Fees for every Series of Units is done based on the pro-rata allocation of the Gross Assets (Total Assets – Total Liabilities) of Fund SER. Management Fees is computed in the following manner:

Gross Assets at the end of Year 1: Rs. 67,60,00,000 – Rs. 3,00,00,000 = **Rs. 64,60,00,000**

Class of Units/Series of Units	Management Fee (%)	Pro-rata Allocation based on Commitments	Pro-rata Share in Gross Assets (Rs.)	Management Fees + GST @ 18% (Rs.)
Class A1 Units: Series A1001 – A1020	1.50%	40%	25,84,00,000	45,73,680
Class A2 Units: Series A2001 – A2010	2.00%	20%	12,92,00,000	30,49,120
Class B1 Units: Series B1001 – B1015	2.00%	30%	19,38,00,000	45,73,680
Class C1 Units: Series C1001 – C1005	2.00%	10%	6,46,00,000	15,24,560
		Total	**64,60,00,000**	**1,37,21,040**

Apart from Management Fees, all other Expenses, Assets and Liabilities will be allocated to specific Series, based on the initial commitments raised. Hence Allocation of Expenses, Assets and Liabilities will be done in the following ratio:

Year 1:

Class of Units/Series of Units	Allocation (%)	Assets (Rs.)	Liabilities (Rs.)	Expenses (Rs.)
Class A1 Units: Series A1001 – A1020	40%	27,04,00,000	1,20,00,000	32,00,000
Class A2 Units: Series A2001 – A2010	20%	13,52,00,000	60,00,000	16,00,000
Class B1 Units: Series B1001 – B1015	30%	20,28,00,000	90,00,000	24,00,000
Class C1 Units: Series C1001 – C1005	10%	6,76,00,000	30,00,000	8,00,000
Total		**67,60,00,000**	**3,00,00,000**	**80,00,000**

Computation of Series NAV – Year 1

Class of Units/ Series of Units (1)	Series Assets (Rs.) (2)	Series Liabilities (Rs.) (3)	Fund Expenses (Rs.) (4)	Manageme nt Fees (Rs.) (5)	Series Net Assets (Rs.) (6) = (2)-(3)-(4)-(5)	No. of units issued (7)	Series NAV per unit (Rs.) (8) = (6)/(7)
Class A1 Units: Series A1001 – A1020	27,04,00,000	1,20,00,000	32,00,000	45,73,680	25,06,26,320	2,00,000	1,253.1316

Class A2 Units: Series A2001 – A2010	13,52,00,000	60,00,000	16,00,000	30,49,120	12,45,50,880	1,00,000	1,245.5088
Class B1 Units: Series B1001 – B1015	20,28,00,000	90,00,000	24,00,000	45,73,680	18,68,26,320	1,50,000	1,245.5088
Class C1 Units: Series C1001 – C1005	6,76,00,000	30,00,000	8,00,000	15,24,560	6,22,75,440	50,000	1,245.5088
Total	**67,60,00,000**	**3,00,00,000**	**80,00,000**	**1,37,21,040**	**62,42,78,960**	**5,00,000**	

Notes: Computation of Series NAV per unit in Year 1:

- Allocation of Fund Assets, Fund Liabilities and Fund Expenses (excluding Management Fees) are done on a pro-rata basis, based on the Opening Commitments received from every class of units/series of units. Management Fees are taken from the calculation made, as per differential rights offered to class of units/series of units.
- It can be observed that the Series NAV per unit of "Class A1 Units: Series A1001 – A1020" is highest at Rs. 1253.1316. This is due to the differential right of lower management fees being charged to this Series of Units.

Gross Assets at the end of Year 2: Rs. 79,80,00,000 – Rs. 3,50,00,000 = **Rs. 76,30,00,000**

Management Fees for Year 2 will be calculated as below:

Class of Units/Series of Units	**Management Fee (%)**	**Pro-rata Allocation based on Commitments at end of Year 1**	**Pro-rata Share in Gross Assets (Rs.)**	**Management Fees + GST @ 18% (Rs.)**
Class A1 Units: Series A1001 – A1020	1.50%	40.15%	30,63,44,500	54,22,298
Class A2 Units: Series A2001 – A2010	2.00%	19.95%	15,22,18,500	35,92,357
Class B1 Units: Series B1001 – B1015	2.00%	29.92%	22,82,89,600	53,87,635
Class C1 Units: Series C1001 – C1005	2.00%	9.98%	7,61,47,400	17,97,079
	Total		**76,30,00,000**	**1,61,99,367**

Allocation of Expenses, Assets and Liabilities will be done in the following ratio:

Class of Units/ Series of Units (1)	Series Assets (Rs.) (2)	Series Liabilities (Rs.) (3)	Fund Expenses (Rs.) (4)	Management Fees (Rs.) (5)	Series Net Assets (Rs.) (6) = (2)-(3)-(4)-(5)	No. of units issued (7)	Series NAV per unit (Rs.) (8) = (6)/(7)
Class A1 Units: Series A1001 – A1020	32,03,97,000	1,40,52,500	12,04,500	54,22,298	29,97,17,702	2,00,000	1,498.5885
Class A2 Units: Series A2001 – A2010	15,92,01,000	69,82,500	5,98,500	35,92,357	14,80,27,643	1,00,000	1,480.2764
Class B1 Units: Series B1001 – B1015	23,87,61,600	1,04,72,000	8,97,600	53,87,635	22,20,04,365	1,50,000	1,480.0291
Class C1 Units: Series C1001 – C1005	7,96,40,400	34,93,000	2,99,400	17,97,079	7,40,50,921	50,000	1,481.0184
Total	**79,80,00,000**	**3,50,00,000**	**30,00,000**	**1,61,99,367**	**74,38,00,631**	**5,00,000**	

Notes:

- Allocation of Fund Assets, Fund Liabilities and Fund Expenses (excluding Management Fees) are done on a pro-rata basis based on the Series Net Assets of the Series in consideration, as a proportion of the Total Net Assets in the fund, at the end of Year 1.
- It is again observed that the Series NAV per unit of “Class A1 Units: Series A1001 – A1020” is highest at Rs. 1498.5885. This is due to the differential right of lower management fees being charged to this Series of Units.
- It can be observed that the allocation percentage used for apportioning Assets, Liabilities and Expenses, for “Class A1 Units – Series A1001 – A1020” has increased minimally from 40% in Year 1 to 40.11% in Year 2. Likewise, the allocation percentage for all the other class of units has decreased minimally. This is primarily on account of the higher NAV per unit at the end of Year 1, for “Class A1 Units – Series A1001 – A1020”. In the years a Category III AIF is increasing its Net Asset Value, it will be beneficial for Class A1 unit holders, as the NAV per unit for Class A1 unit holders will increase slightly more than the NAV for other unit holders in the fund.

As per recent SEBI Circular, no Category III AIF can adopt such a 'priority distribution model', in which one class of investors are getting a higher share of profits, at the cost of another class of investors. The Investment Manager will need to inform this to all the investors and get their approval, before issuing units with such differential rights to one class of investor.

8.4 Role of third-party Registered Valuers

Under SEBI (Alternative Investment Funds) Regulations, 2012, all Category III AIFs shall ensure that calculation of the Net Asset Value (NAV) is independent from the fund management function.

- Unlisted securities should be valued at the "best estimate" price which represents the true and fair market value of such unlisted securities.
- Derivative contracts traded in over the counter (OTC) markets, which do not have a fixed price on a recognized stock exchange, shall be valued at fair value to compute the mark-to-market margin and resulting gains or losses.
- Derivative contracts traded in international markets shall be fairly valued in domestic currency, as on the relevant valuation day.
- Concentrated positions taken in unlisted securities, such as small-cap companies or SME companies should be valued at the Fair Market Value (FMV), after considering the impact of low trading volumes on the exit price for the Category III AIF.

Leverage is a crucial risk factor for Category III AIFs. The Investment Manager should ensure that the Category III AIF is within the prescribed Leverage Limits, specified by SEBI, based on the true and fair valuation of the Fund Assets and Liabilities.

In case the Category III AIF is dealing solely in listed securities, the price of such securities on the exchange platform shall be taken for the purpose of valuation.

The NAV of a Category III AIF shall be disclosed to all investors on quarterly basis, if the fund is structured as a closed-ended Category III AIF and on monthly basis, if the fund is structured as an open-ended Category III AIF. The Category III AIF should provide the description of its valuation procedure and methodology for valuing assets to its investors.

Chapter 8: Sample Questions

1. **Which of the following positions in F&O are eligible to be considering as offsetting positions, to compute the maximum permissible Leverage for a Category III AIF?**

   a. A Call Option and a Put Option on a different underlying asset, but with the same strike price
   b. **A Call Option and a Put Option on the same underlying asset, but with different strike price**
   c. A Long Futures Contract and a Call option on the same underlying asset
   d. A Long Futures Contract and a Put option on a different underlying asset

2. **A Category III AIF is permitted to trade in Commodity Derivatives contracts up to a limit of 10 percent of its investable funds in one underlying commodity. State whether True or False.**

   a. **True**
   b. False

3. **Which of the following securities would least likely be valued at Fair Market Value, by a Category III AIF?**

   a. Listed Equities
   b. **Unlisted Equities**
   c. Exposure in Commodity Derivative Contracts
   d. Units of a mutual fund

4. **________is computed for investors in a series of units to report the value of assets attributable per unit, as reduced by the liabilities and expenses apportioned to such series, as on a Valuation Day.**

   a. Fund NAV
   b. Class NAV
   c. **Series NAV**
   d. Series Assets

5. **The NAV of a Category III AIF shall be disclosed to all investors on quarterly basis, if the fund is structured as an open-ended Category III AIF. State whether True or False.**

   a. True
   b. **False**

Chapter 9: Taxation

LEARNING OBJECTIVES:
After studying this chapter, you should know about: • Tax regime for Category III AIFs in India • Concepts of Determinate/ Indeterminate Trusts and Revocable/ Irrevocable Trusts • Taxability of business income, capital gains and dividends • Goods and Services Tax regime for Category III AIFs in India • Taxability on transfer/ distribution/ redemption of units • Tax regime applicable for Category III AIFs in IFSC • Impact of direct and indirect taxes on Category III AIF performance

9.1 Comparison of Tax-regime among all categories of AIFs

As per SEBI (Alternative Investment Funds) Regulations, a Category III AIF can be registered with SEBI as a Trust, Company, Limited Liability Partnership (LLP), or a Body Corporate, by filing Form A with the regulator and paying the applicable registration fees. Taxation of gains arising from investments is either paid by the investors in the fund, or by the AIF on behalf of its investors, to avoid double taxation. "Tax pass-through" status of an entity means that the AIF, under consideration, is not obliged to pay income tax on income generated by the AIF. The investors in such AIF are obliged to pay tax on income distributed by the fund to such investors, while filing their respective income tax returns. Prior to introduction of Finance Act, 2015, most AIFs were set-up as a "Trust" in order to get the benefit of "tax pass-through". This is because under the Indian Trusts Act, 1882, an "Irrevocable Trust" whose beneficiaries are ascertained, at the time of filing the Trust Deed, is eligible for a "tax pass-through".

To understand the tax-regime for Category III AIFs, it is important to understand the applicability of following provisions of Income Tax Act, 1961, as amended from time to time.

- **Tax Pass-through Status of an AIF:**

The Finance Act, 2015 incorporated a tax-pass through status for an "Investment Fund", through Section 115UB of the Income Tax Act, 1961. As per Section 115UB, any income accruing to, or received by a unit holder of an "Investment Fund" shall be considered as income accruing to, or received by, the unit-holder in the fund.

Section 115UB defines "Investment Funds" as follows:

*"**Investment Fund**" means 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 Securities and Exchange Board of India (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 Authority Act, 2019;*

As per the definition of "Investment Fund" mentioned in Section 115UB, Category III AIFs are not considered as Investment Funds and hence, not accorded the tax pass-through status.

- **Nature of Taxable Income for the Investment Fund and Unit Holders in an AIF:**

Section 115UB further provides that any income accruing to, or received by a unit holder of an Investment Fund shall be chargeable to income-tax in the same manner as if it was income accruing to, or received by, the unit-holder in the fund.

As per Section 115UB, the nature of income streams in the hands of investment fund and in the hands of unit holders shall be considered identical. However, on account of Section 10(23FBA) and Section 10(23FBB) of the Income Tax Act, 1961, the nature of the income streams in the hands of investment fund and in the hands of unit holders is different.

- Section 10(23FBA) provides that income of the "Investment fund", other than 'profits or gains from business or profession', shall be exempt from taxation. Accordingly, income of the Investment Fund under the heads of 'Capital Gains' or 'Income from Other Sources' is exempted from tax, at fund-level.
- Section 10(23FBB) provides that income accrued to, or received by the unit holder, in the nature of 'profits or gains from business or profession' earned by the Investment Fund, is exempted from tax, in the hands of unit holders.

After consideration of Section 10(23FBA) and 10(23FBB), any income generated by the AIF, in the nature of 'profits or gains from business or profession' is taxable in the hands of Investment Fund. Any income accrued to, or received by, a unit holder in the AIF in the nature of 'Capital Gains' or 'Income from Other Sources' shall be taxable at the applicable income tax slab rates for the unit holder.

- **Applicable Tax Rates for a Category III AIF:**

Sub-section (4) of section 115UB provides:

- Where the Investment Fund is formed as a Company or a Limited Liability Partnership (LLP), total income of such Investment Fund shall be charged to tax, as per the rates applicable to Company or an LLP.
- Where the Investment Fund is formed as a Trust, total income of such Investment Fund shall be charged to tax, at the Maximum Marginal Rate (MMR), currently at 30%.

- **Effective Tax Rate for a Category III AIF, considering Surcharge as well as Health and Education Cess:**

The surcharge applicable to income, other than Capital Gains under Section 111A and Section 112A, generated by domestic Individuals, Hindu Undivided Family (HUFs), Associations of Persons (AoP) and Body of Individuals (BoI) is as follows:[134]

Income Slab	Surcharge Rate
Total income exceeding Rs. 50 lakh but not exceeding Rs. 1 crore	10%
Total income exceeding Rs. 1 crore but not exceeding Rs. 2 crore	15%
Total income exceeding Rs. 2 crore but not exceeding Rs. 5 crore	25%
Total income exceeding Rs. 5 crore	37%

The Surcharge is calculated on the tax liability of the assessee at these applicable rates. Further, Health and Education Cess at the rate of 4% is levied on aggregate of tax and surcharge.

As a result of the increased surcharge, the effective tax rate for individuals and assessees earning income of more than Rs. 2 crore, is as follows:

Particulars	Applicable Surcharge and Cess	Effective Tax Rate	Increase in Tax Rate
Annual Income between Rs. 2 crore and Rs. 5 crore	25% + 4% Health & Education Cess	39.00%	3.12%
Annual Income in excess of Rs. 5 crore	37% + 4% Health & Education Cess	42.74%	6.86%

The surcharge applicable to income generated by domestic companies shall be as follows:

Income Slab	Surcharge Rate
Total income exceeds Rs. 1 crore but does not exceed Rs. 10 crore	7%
Total income exceeds Rs. 10 crore	12%

The Surcharge is calculated on the tax liability of the assessee at these applicable rates. However, surcharge at flat rate of 10% shall be levied on base tax for the companies opting

[134] Under new tax regime, the maximum surcharge is charged at 25% for total income exceeding Rs. 2 crore.

for lower rate of tax of 22% or 15%.[135] Further, Health and Education Cess at the rate of 4% is levied on aggregate of tax and surcharge.

Category III AIFs categorizing their income as 'Profits and Gains from Business or Profession' are also subject to surcharge rates, over and above the tax levied at Maximum Marginal Rate (MMR). Due to the high tax rates, all the underlying unit holders investing in units of Category III AIFs indirectly bear the tax expense, unless some investors get the preferential tax treatment on account of 'Most Favoured Nation' (MFN) clauses in the Investor Side Letters signed with the Category III AIFs.

- **Treatment of Losses:**

Under Section 115UB of the Income Tax Act 1961, all investment funds registered as Category I AIFs or Category II AIFs are treated as pass through entities and income earned by such AIFs, other than business income, is taxed directly in the hands of unit holders.

However, as per sub-section (2) of Section 115UB, losses incurred by the investment funds are not passed on to the unit holders and hence, are carried forward or set off by the AIF in accordance with Chapter VI of Income Tax Act. With the subsequent amendments made to sub-section (2) of section 115UB, the treatment of losses incurred by the Investment Funds is as follows:

- Business losses of the Investment Fund shall be carried forward and set-off by the investment fund, from taxable income.

- Losses, other than business losses, shall not be passed through to the unit holders, if such losses arise in respect of units held by the unit holders for less than 12 months.

- Losses, other than business loss, accumulated at the level of investment fund as on 31st March, 2019, shall be deemed to be the loss of a unit holder who has held units in the fund as on 31st March, 2019, in respect of the investments made by him in the investment fund. Such unit holder shall be allowed to carry forward the loss in his/her returns, until the expiry of 8 years from the year in which the loss was first incurred by the investment fund. This enables unit holders to utilize losses which would have been retained at the investment fund level and probably not been available for carry forward and set-off, in the hands of the investors.

- All losses deemed as losses in the hands of the unit holders shall not be available to the investment fund for the purpose of set-off or carry-forward of losses in future.

[135]These lower rates are subject to fulfilment of certain conditions as provided in Section 115BAA and Section 115BAB of the Income Tax Act, 1961 respectively.

This tax-regime and Section 115UB of the Income tax Act, 1961, provides tax pass-through only to Category I AIF and Category II AIF. As the regime is not applicable to Category III AIFs, a bottleneck continues to exist for taxation-related issues. The income earned by a Category III AIF is taxed at the Maximum Marginal Rate (MMR), in the hands of the Fund, as tax pass-through status is not accorded to Category III AIFs and most Category III AIFs are set-up as a "Trust" structure. Tax-rates applicable to the Category III AIF are further determined by the source and nature of income, such as 'Capital Gains' or 'Income from Other Sources'.

9.2 Taxation principles applicable to Trust structure

Tax-regime for a Category III AIF depends on the legal structure of the entity. Most AIFs are set-up as a "Trust" in order to get the benefit of "tax pass-through" and also due to the ability to incorporate bespoke terms of governance for an AIF, as may be agreed between the sponsor and the unit holders. The Indian Trusts Act, 1882 governs the creation and operation of private trusts for the purpose of collecting and managing pools of capital. The Indian Trusts Act is read in conjunction with relevant provisions of the Income Tax Act, 1961, to determine whether a Trust qualifies for a 'tax pass-through status', for payment of income tax.

A "Trust" is a legal entity set-up, for transfer of property from one person to another, with the intention that the Trust is administered for the benefit of the owners. The person who transfers the property is called a "Settlor". The person to whom the property is transferred is called the Trustee. The person for whose benefit the trust is created is called the "beneficiary". A Trust is created when the Settlor indicates his intention to create a trust. In order to create a trust, the Settlor specifies the Trust Property, purpose of creating the Trust and identifies the beneficiaries of the Trust.

9.2.1 Determinate Trust vs. Indeterminate Trust

A "Determinate Trust" is a Trust wherein the trust beneficiaries, and their respective beneficial interests, are ascertainable as per the terms of the 'Indenture of Trust' or the 'Trust Deed', at all times during its existence. An AIF set-up as a Trust will be considered as a Determinate Trust, if the unit holders along with their beneficial interest in the Fund, are ascertainable through the 'Indenture of Trust' or the 'Trust Deed' during the entire tenure of the fund.

An "Indeterminate Trust" is a Trust wherein the trust beneficiaries, and their respective beneficial interests, are not ascertainable as per the terms of the 'Indenture of Trust' or the 'Trust Deed'. Indeterminate Trusts can also be Discretionary Trusts, where the trustee exercises discretion on utilisation of the assets of the trust, determines beneficial interest and also exercises discretion over the distribution of income of the Trust. However, Non-discretionary Trusts are administered as per the clauses of the trust deed and are not driven on the discretion of the trustee.

In order to ascertain whether a Trust is a "Determinate Trust" or not, the Income Tax Appellate Tribunal has clarified that:

- The beneficiaries as well as their beneficial interests must be capable of being ascertained on the date of the trust deed itself, without leaving these to be decided upon at future date, by a person other than the settlor. However, if the Trust deed authorises addition of further contributors to the trust at different points of time, in addition to initial contributors, then the same would not make the beneficiaries unknown, or make their share indeterminate.

Taxation Principles: If an AIF has been set up as a trust, the Trustee would be assessed as a 'representative assessee' under the provisions of Section 161 and Section 164 of the Income Tax Act, 1961.

<u>Determinate Trusts:</u>

As per Section 161(1A) of the Income Tax Act, 1961, if the income of the determinate trust includes income in the nature of 'Profits or Gains from Business and Profession', such income shall be subject to tax at Maximum Marginal Rate of tax (MMR), payable by Trustee. As per Section 161(1) of the Income Tax Act, 1961, if the Determinate Trust earns income other than in the nature of 'Profits or Gains from Business and Profession', the Assessing Officer (AO) can permit assessment of such income in the hands of the Trustee, wherein the Trustee would be assessed as a 'representative assessee' of the fund. Hence, the Maximum Marginal Rate of tax may not be applicable in this case, specifically on income from Capital Gains. This section provides that tax shall be levied upon and recovered from the Trustee, in the like manner and to the same extent as it would be levied upon and recoverable from the beneficiaries of the Trust, i.e. the unit holders in the fund.

Once the income is taxed in the hands of the Trustee as a Representative Assessee, there will be no further income tax implications on subsequent distribution of the income by the trustee in the hands of the beneficiaries. However, as per Section 166 of the Income Tax Act, 1961, the Assessing Officer may assess the income directly in the hands of beneficiaries, i.e. the unit holders in the fund, provided the Trustee has not been taxed on such income. In such an event, any income tax paid by the Trustee in their capacity as a Representative Assessee should be in-principally available as credit against the income tax liability of the beneficiaries.

<u>Indeterminate Trusts:</u>

In case of an Indeterminate Trust, the trust beneficiaries, along-with their beneficial interests, are not specified in the Indenture of Trust. As per Section 164 of the Income Tax Act, 1961, the Trustee shall be assessed as a 'representative assessee' and pay income tax on income earned by the fund at the Maximum Marginal Rate of tax (MMR). Since the beneficiaries are not known, the provisions of Section 166 of the Income Tax Act, 1961 will not be invoked and hence, no income will be taxed in the hands of the unit holders.

9.2.2 Revocable Trust vs. Irrevocable Trust

An “Irrevocable Trust” is a Trust in which the Settlor of the Trust does not have powers to revoke the trust and the trust shall continue operations, until its purpose is served or stipulated tenure is complete. An AIF is structured as an Irrevocable Trust, if the fund will not be revoked by the (a) consent of all the beneficiaries, (b) Settlor, in exercise of powers of revocation, expressly reserved for the Settlor.

A transfer of an asset is considered revocable when the contribution agreement contains a provision for:

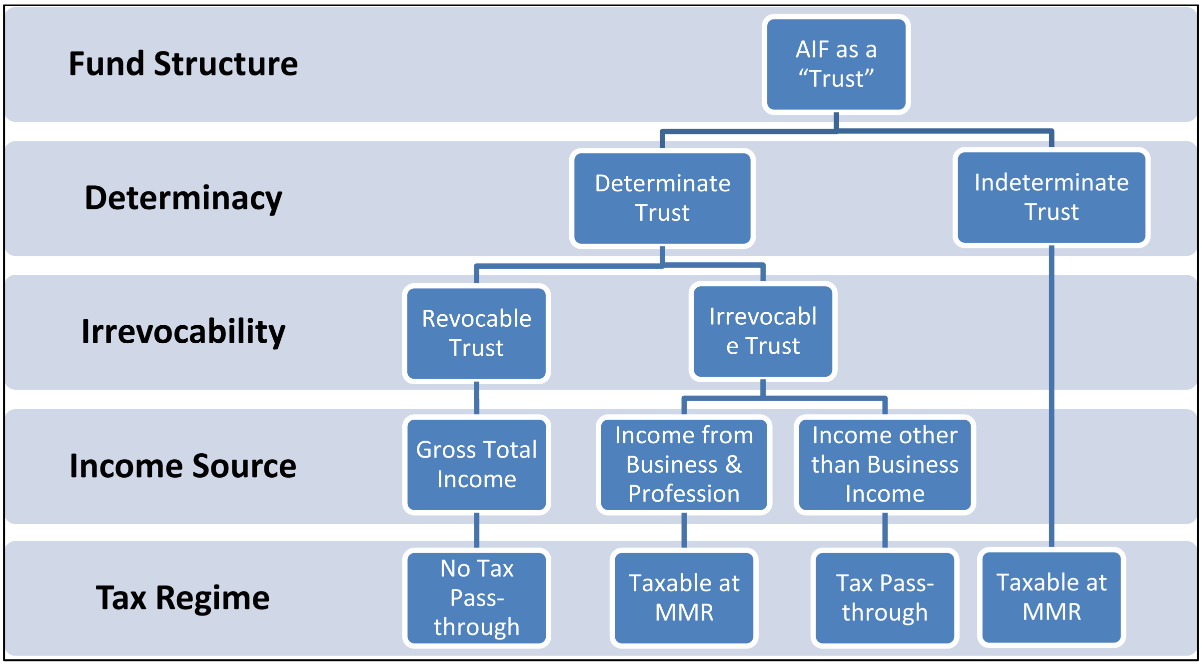
- the re-transfer, directly or indirectly, of the income earned from the asset to the transferor, or
- giving a right to the transferor to reassume power, directly or indirectly, over the whole or any part of the income or asset.

A “Revocable Trust” is a Trust which can be revoked by the Settlor of such Trust, at their discretion or as per the consent of the beneficiaries. An AIF, structured as a Revocable Trust, may be revoked at any time before the completion of fund tenure. As long as power to revoke exists with the Settlor of the Trust, the manner of revocation is not taken in to consideration to ascertain the tax liability of the Trust. Hence, partial revocation is also acceptable as a power to revoke, and considered as a “Revocable Trust”.

Taxation Principles: As per Section 61 of the Income Tax Act, 1961, in case of a revocable transfer of assets, all income arising by virtue of such revocable transfer shall be chargeable to tax as the income of the transferor and shall be included in total income of the transferor. Hence, if an AIF is set-up as a revocable trust and makes a revocable transfer of assets, income accruing to the fund on account of such transfer will not be eligible for a tax pass-through.
In case of an irrevocable transfer, the tax treatment will be determined on the basis of whether the respective shares of the beneficiaries in the Trust are determinate or not.

Figure 9.1 summarizes the tax treatment of Determinate Trusts and Indeterminate Trusts, whether structured as a Revocable Trust or Irrevocable Trust:

Figure 9.1: Tax pass-through status of AIF set-up as a "Determinate" and "Irrevocable" Trust



9.3 Tax applicability on income from Category III AIFs

As seen from the direct taxation regime discussed above, taxation on income earned by a Category III AIF is dependent on the stream of income, as defined under the relevant provisions of the Income Tax Act, 1961. If an AIF is structured as an 'Irrevocable Determinate Trust', income earned under the head 'Profits or Gains from business and profession' is taxable at the Maximum Marginal Rate (MMR). All other sources of income, including income from 'Capital Gains' and 'Income from Other Sources' are eligible for a tax pass-through, wherein the beneficiaries in the trust are taxed at the applicable income tax rate on such income, for the relevant financial year.

The unit holders in a Category III AIF would primarily earn income from the following streams:

- Interest income
- Dividend income
- Gains on transfer of listed shares or mutual fund units
- Gains on transfer of listed and unlisted bonds or debentures
- Gains arising from transaction in derivatives such as futures and options
- Gains on transfer of units of the Fund

The tax applicability on all these streams of income is discussed below:

9.3.1 Taxation of Interest income

Interest income accrues to the Category III AIF on debt investments made in the investee companies, through debentures and bonds. The interest income is subject to tax in the hands of all unit holders, as per the rate of income tax applicable to every unit holder investing in the fund.

9.3.2 Taxation of Dividend income

The Finance Act, 2020 has withdrawn the Dividend Distribution Tax (DDT) under section 115-O, liable to be paid by domestic companies on dividends declared out of accumulated profits. Financial Year 2020-2021 onwards, section 10(34) of the Income Tax Act, 1961, has also been withdrawn, which exempts dividends received by investors from a domestic company from income tax. Thus, if dividend is distributed on or after April 1, 2020, the domestic companies shall not be liable to pay DDT and, consequently, the investors shall be liable to pay tax on such dividend income.

A Category III AIF would now be liable to pay tax on Dividend Income received from domestic companies in India. If the fund treats its investment in the shares of a domestic company as ‘stock-in-trade’ or is held for trading purposes, any dividend income received thereon would be taxed as ‘Profits or Gains from Business or Profession’. In this case, the fund can claim a deduction of all such expenditures incurred to earn the dividend income, including collection charges and interest on loan taken. However, if the fund treats such shares in the domestic company as ‘investments’, any dividend income received thereon would be taxed as ‘Income from Other Sources’, and tax thereon would be paid by the fund as a representative assessee if the Category III AIF is structured as an ‘Irrevocable Determinate Trust’. In this case, the fund can claim a deduction of only interest expenditure incurred to earn the dividend income, to the extent of 20% of the total dividend income. No other deduction is allowed for any other expense, such as commission or remuneration paid to a banker.

As per Section 194 of the Income Tax Act, 1961, an Indian company shall deduct tax at the rate of 10% from dividend distributed and paid, on or after April 1, 2020, to resident shareholders such as Category III AIFs. Section 194 shall be applicable if the aggregate amount of dividend distributed or paid during the financial year to the Category III AIF exceeds Rs. 5,000.

9.3.3 Taxation of Capital Gains on Listed and Unlisted Securities

As per Section 45 of the Income Tax Act, 1961, 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 Income Tax Act, 1961 provides that income chargeable as capital gains would be computed as follows:

Full Value of Consideration:	**XXX**
Less: Cost of Acquisition/Indexed Cost of Acquisition	(XXX)
Less: Cost of Improvement incurred in relation to the asset transferred	(XXX)
Less: Expenditure incurred wholly and exclusively in connection with the transfer of the asset	(XXX)
Long Term Capital Gain / Short Term Capital Gain:	**XXX**

The following table 9.1 summarizes the applicable tax rates, for F.Y. 2021-2022 on “Capital Gains” for a Category III AIF:

Table9.1: Tax Rates Applicable on Capital Gains

Particulars	Income Head – Capital Gains	
	Short-term Capital Gain [1]	**Long-term Capital Gain [1]**
Listed equity shares and units of equity-oriented scheme	15% (where STT[2] is paid)	10% on amount in excess of Rs. 1 lakh (where STT is paid and amount of capital gain exceeds Rs. 1 lakh in a financial year)
Listed bonds and debentures	At tax slab rates of the individual (i.e. 30% if in highest tax slab)	10% (without indexation) OR 20% (with indexation)
Unlisted bonds and debentures	30%	20%
Units of a non-equity oriented scheme	At tax slab rates of the individual (i.e. 30% if in highest tax slab)	At tax slab rates of the individual (w.e.f. April 1, 2023)
Unlisted equity shares	30%	20% (with indexation)

[1]Tax on Short-term Capital Gain and Long-term Capital Gain is excluding applicable Surcharge and Health and Education Cess.
[2]STT – Securities Transaction Tax is applicable on equity shares, derivatives and units of equity-oriented mutual funds.

- **Applicable STT Rates:**
  - Delivery-based purchase and sale of equity shares, traded on a recognized stock exchange in India, are subject to STT at the rate of 0.1% on the transaction value of such purchase or sale.
  - No STT is applicable on purchase of units of equity-oriented mutual funds. However, STT at the rate of 0.001% is levied on the delivery-based sale of units of equity-oriented mutual funds, traded on a recognized stock exchange in India.
  - STT is levied on the seller at the rate of 0.0625% on the sale of option in securities. However, STT is levied on the purchaser at the rate of 0.125% on sale of option in securities, where the option is exercised. STT is levied on the seller at the rate of 0.0125% on the sale of futures in securities.
  - STT is levied on the seller at the rate of 0.025% on the sale of equity shares in a company or units of business trust or units of an equity oriented mutual fund, settled otherwise than by actual delivery and transaction on a recognized Stock Exchange in India.
  - STT at the rate of 0.2% on the transaction value is levied on sale of unlisted equity shares and units of business trust under an initial public offer.

Under Section 2(42A) of the Income Tax Act, 1961, 'short-term capital asset' is a capital asset held by the assessee, for a period not more than:

- 12 months immediately preceding the date of transfer, in case of securities listed on a recognized stock exchange, a unit of an equity oriented fund, listed bonds and debentures, or a zero coupon bond.

- 24 months, immediately preceding the date of transfer, in case of shares held of company not being listed on a recognized stock exchange.

- 36 months, immediately preceding the date of transfer, in case of debentures held of company not being listed on a recognized stock exchange of units of a non-equity-oriented fund.

Section 112A of the Income Tax Act, 1961 was introduced by Finance Act 2018, to tax long-term capital gains arising from the sale of listed equity shares, units of equity-oriented mutual funds and units of business trust. As per Section 112A(2), if the long-term capital gains on transfer of listed equity shares, units of an equity-oriented mutual fund or units of a business trust exceed Rs. 1 lakh, then the amount in excess of Rs. 1 lakh is taxable at a rate of 10%. The surcharge applicable is 15% and Health & Education Cess applicable is 4%. A Category III AIF will be liable to pay tax as per the provisions of Section 112A, provided:

- There is a sale of listed equity shares, units of an equity-oriented mutual fund or units of a business trust, which are held for a period of more than 12 months from the date of purchase.

- The fund has paid the applicable Securities Transaction Tax (STT) on the purchase and sale of equity shares. In case of equity-oriented mutual fund units or business trust, the fund has paid the applicable STT on the sale of units.

Section 111A of the Income Tax Act, 1961 is applicable on short-term capital gains arising from the sale of listed equity shares, units of equity-oriented mutual funds and units of business trust. Short-term Capital Gains under Section 111A are taxed at 15%, the surcharge applicable is 15% and Health & Education Cess applicable is 4%. A Category III AIF can take the benefit of such concessional tax rates in the following circumstances:

- Short-term Capital Gains earned on sale of equity shares listed on a recognised stock exchange, chargeable to STT.

- Short-term Capital Gains earned on sale of units of an equity oriented mutual fund or units of a business trust sold through a recognised stock exchange, chargeable to STT.

- Short-term Capital Gains earned on sale of equity shares, units of equity oriented mutual funds or units of a business trust through a recognised stock exchange located in IFSC and consideration is paid or payable in foreign currency. Such a sale transaction is eligible for the concessional rate under section 111A even if STT is not paid on such transaction.

The concessional tax rates applicable on income from Capital Gains should gain precedence over the maximum marginal rate under Section 164 of the Income Tax Act, 1961. However, the Income Tax authorities have a right to take a contrary view and charge such income at the maximum marginal rate.

Due to the nature of business carried out by a Category III AIF, there have been disputes on whether income earned by the fund, from the sale of shares and securities held by the fund, should be treated as income under 'Capital Gains' or income under 'Profits and Gains from Business and Profession'. Disputes are also on account of the difference in the tax rates payable by Category III AIFs, on the income earned under 'Profits and Gains from Business and Profession' and income earned under 'Capital Gains'.

In the securities markets and through investment strategies adopted by Indian Category III AIFs, a majority of transactions take place in respect of listed shares and securities. In order to reduce litigation and to maintain consistency in approach on the issue of treatment of income derived from transfer of listed shares and securities, the Central Board of Direct Taxes (CBDT) has issued a circular that aims to provide consistency in the taxability of the income generated by a Category III AIF, on account of transfer of listed shares and securities.[136] The CBDT has instructed the Assessing Officers (AO) to consider the following principles for treatment of income derived from transfer of listed shares and securities, as either capital gain or business income:

- If the Category III AIF opts to treat listed shares and securities as stock-in-trade, then irrespective of the period of holding of such securities, any income arising from transfer of such shares and securities would be treated as income under 'Profits and Gains from Business and Profession'.

- In respect of listed shares and securities held for a period of more than 12 months, immediately preceding the date of transfer, if the Category III AIF opts to treat income arising from such transfer as 'Capital Gains', the same shall not be put to dispute by the Assessing Officer. However, once this option is taken by the Category III AIF in a particular assessment year, the fund shall be bound to treat all such income, in subsequent assessment years, as income under 'Capital Gains'.

- Such option given to Category III AIFs and above principles for categorization will not apply for those transactions, where there is a question on the genuineness of the transaction, such as bogus claims of long-term capital gain, short-term capital loss or any other sham transactions.

- Gains arising on buy back of shares listed on a recognized stock exchange should be taxed in the similar manner as the gains on sale of listed shares and securities.

Similarly, to have a consistent view in assessment and to avoid disputes pertaining to income arising from transfer of unlisted shares and securities, by a Category III AIF, the CBDT has

[136]Vide CBDT Circular No.: 6/2016 dated February 29, 2016.

further clarified that the income arising from transfer of unlisted shares would be considered under the head 'Capital Gains' irrespective of holding.[137] Such assumption would however not apply to situations where:

- the genuineness of the sale of unlisted shares is questionable; or
- the transfer 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 the underlying business.

The Assessing Officer in the aforesaid cases will take a view depending on the facts and circumstances of each case.

It is to be noted that the aforesaid circulars issued by CBDT provide the required clarity in respect of capital gains arising from listed shares and unlisted shares. However, there is still a clarification required from treatment of gains arising from sale of following securities:

- Sale of listed investments held for less than 12 months;
- Sale of unlisted securities, other than shares;
- Income arising from debt investments to an AIF that makes investments in debt securities

9.3.4 Taxation of Gains arising from Transactions in Derivative Contracts such as Futures and Options:

Category III AIFs take exposure in futures and options contracts, for the purpose of hedging or taking additional leverage. Any gains arising from these transactions shall be treated as 'Profits and Gains from Business and Profession' and the fund should be liable to pay tax on such income at the Maximum Marginal Rate of Tax, i.e. 42.744%.

9.3.5 Taxation of Deemed Income on Investment in Shares and Securities in India:

Category III AIFs may acquire shares of an Investee Company, for a consideration lower than the Fair Market Value (FMV) of such shares. As per Section 56(2)(x) of the Income Tax Act, 1961, if the Category III AIF acquires any shares or securities for a consideration below the Fair Market Value of such shares or securities, then the difference between the consideration paid and the Fair Market Value shall be taxable in the hands of the Category III AIF, as 'Income from Other Sources'.

Let us understand the taxation of different sources of income of a Category III AIF:

Example 1: Fund TI

Fund TI was launched in the year 2018, as an Irrevocable, Determinate Trust, with an aim to primarily make equity investments and debt investments only:

[137]Vide CBDT Letter No.:F.No.225/12/2016/ITA.II dated May 2, 2016.

Particulars	Amount
Committed Capital (Rs.)	60,00,00,000
No. of units issued	6,00,000
NAV (Rs.)	1000.00

Fund TI made the following investments on April 01, 2018:

Particulars	Quantity	Rate	Amount (Rs.)
Listed Equities:			
Company ABC	50,000	825.00	4,12,50,000.00
Company XYZ	1,00,000	1,175.00	11,75,00,000.00
Company PQC	10,00,000	145.00	14,50,00,000.00
Company LMN	75,000	2,250.00	16,87,50,000.00
			47,25,00,000.00
Unlisted Equities:			
Company SME	1,50,000	115.00	1,72,50,000.00
Company AEC	10,00,000	105.00	10,50,00,000.00
			12,22,50,000.00

The Fund liquidates the holdings after three years, ending on March 31, 2021. The following table provides details of the income and expenses for Fund TI, during the years.

Particulars	F.Y. 2018-2019	F.Y. 2019-2020	F.Y. 2020-2021
Dividend Income	3,50,00,000	3,80,00,000	3,95,00,000
Dividend Collection Costs	5,00,000	5,50,000	6,00,000
Management Fees @ 2% (including GST)	1,53,80,000	1,59,35,000	1,65,20,000
Fixed Yearly Expenses	25,00,000	25,00,000	25,00,000
Securities Transaction Tax on purchase of listed equities	4,72,500	-	-

Fair Market Value of the Investments, at end of each financial year is provided below:

Particulars	As on March 31, 2019	As on March 31, 2020	As on March 31, 2021
Company ABC	845.00	900.00	965.00
Company XYZ	1125.00	1250.00	1185.00
Company PQC	165.00	185.00	195.00
Company LMN	2480.00	2380.00	2585.00
Company SME	180.00	175.00	195.00
Company AEC	107.00	118.00	130.00

Compute the taxable income and tax payable by Fund TI, in the following scenario:

A. Fund TI treats the investments as 'stock-in-trade' and files yearly return, showing income earned as 'Profits and Gains from Business or Profession'

B. Fund TI treats the income earned from sale of investments as 'Capital Gains'.
   a. The Fund has sold all listed equities in F.Y. 2019-2020, on March 31, 2020. STT paid at the time of sale of listed equities, in F.Y. 2019-2020 was Rs. 5,33,500
   b. Company SME and Company AEC had issued shares through an Initial Public Offering (IPO) in F.Y. 2019-2020. The Fund has sold its shares in both these companies in F.Y. 2020-2021, on March 31, 2021, after a six-month lock-in. STT paid at the time of sale of such securities, in F.Y. 2020-2021 was Rs. 1,59,250

Solution:

Scenario A: Treating income as 'Profits and Gains from Business or Profession':

In this scenario, investments will be carried forward in the Balance Sheet of Fund TI, at Fair Market Value, computed as per the valuation standards. Profit or loss will be recognized as 'Profits and Gains from Business or Profession', at the end of every financial year.

Dividend Income will be recognized as 'Profits and Gains from Business or Profession' after claiming deduction of allowable expenses. Dividend Collection Costs are an allowable expense, if Dividend Income is recognized as 'Profits and Gains from Business or Profession'.

Computation of 'Profits and Gains from Business or Profession':

Particulars	F.Y. 2018-2019	F.Y. 2019-2020	F.Y. 2020-2021
A. Profit/(Loss) from Fair Valuation of Stock-in-trade:			
Company ABC	10,00,000	27,50,000	32,50,000
Company XYZ	-50,00,000	1,25,00,000	-65,00,000
Company PQC	2,00,00,000	2,00,00,000	1,00,00,000
Company LMN	1,72,50,000	-75,00,000	1,53,75,000
Company SME	97,50,000	-7,50,000	30,00,000
Company AEC	20,00,000	1,10,00,000	1,20,00,000
Total Income	**4,50,00,000**	**3,80,00,000**	**3,71,25,000**
<u>Less: Deductions allowed:</u>			
Less: Management Fees	- 1,53,80,000	- 1,59,35,000	- 1,65,20,000
Less: Fixed Yearly Costs	- 25,00,000	- 25,00,000	- 25,00,000
Less: STT paid on purchase of listed equities	-4,72,500		
Net Profit from Business Activities: [A]	**2,66,47,500**	**1,95,65,000**	**1,81,05,000**

Particulars	F.Y. 2018-2019	F.Y. 2019-2020	F.Y. 2020-2021
B. Dividend Income from Investments held as Stock-in-trade:			
Dividend Income	3,50,00,000	3,80,00,000	3,95,00,000
Less: Deductions allowed:			
Dividend Collection Costs	- 5,00,000	- 5,50,000	- 6,00,000
Net Dividend Income: [B]	**3,45,00,000**	**3,74,50,000**	**3,89,00,000**
Profits and Gains from Business or Profession [A + B]	**6,11,47,500**	**5,70,15,000**	**5,70,05,000**

Computation of Tax Liability:

Particulars	F.Y. 2018-2019	F.Y. 2019-2020	F.Y. 2020-2021
Profits and Gains from Business or Profession	6,11,47,500	5,70,15,000	5,70,05,000
Gross Total Income	**6,11,47,500**	**5,70,15,000**	**5,70,05,000**
Tax Rate @ 30% on Business Income	1,83,44,250	1,71,04,500	1,71,01,500
Add: Surcharge @ 37%	67,87,373	63,28,665	63,27,555
Add: Health &Education Cess @ 4%	10,05,265	9,37,327	9,37,162
Net Tax Payable	**2,61,36,887**	**2,43,70,492**	**2,43,66,217**

Notes:

- Based on the trust structure, Fund TI is liable to pay tax on the income earned as ‘Profits or Gains from Business and Profession’ at the maximum marginal rate.

- Profit/ (Loss) from Fair Valuation of Stock-in-trade is computed for every financial year, by taking the difference between the opening and closing fair market values.

- Since Fund TI has categorized income under the head ‘Profits or Gains from Business and Profession’, the yearly expenses and management fees paid by the fund are tax deductible from the income.

- Securities Transaction Tax (STT) would be paid by Fund TI at the time of purchase of listed equity shares, at the rate of 0.1% on the transaction value of such purchase. Such STT is allowed as a deduction from the income under 'Profits or Gains from Business and Profession', as the same can be shown as a business expense.

- Once the fund has paid tax, unit holders will not be required to pay tax on capital gains, on account of increase in value of the securities held by the Fund.

- The Total Income of Fund TI exceeds Rs. 5 crore in all the financial years, throughout the life of the fund. Hence, the enhanced surcharge rate shall be applicable, i.e. 37%. Health and Education Cess is levied at the rate of 4% on the amount of income-tax plus surcharge.

Scenario B: Treating income as 'Capital Gains':

In this scenario, investments will be carried forward in the Balance Sheet of Fund TI, at Fair Market Value, computed as per the valuation standards. Profit or loss will be recognized as 'Capital Gains', in the financial year in which the fund has made a 'transfer' or 'sale' of the investments held by the fund.

Dividend Income will be recognized as 'Income from Other Sources' after claiming deduction of allowable expenses. Dividend Collection Costs are not deductible, if Dividend Income is recognized as 'Income from Other Sources'. As discussed above, only interest expenditure, to the extent of 20% of the total dividend income, is allowed as a deduction.

In this example, all listed securities, i.e. equity securities, held by the fund are sold on March 31, 2020. Hence, the fund will be liable to pay 'long-term capital gain tax' on transfer of such securities at 10%, as holding period is more than 12 months, from the date of investment.

Similarly, all unlisted securities held by the fund are sold on March 31, 2021 at the time of liquidation of the fund. Hence, the fund will be liable to pay 'long-term capital gain tax' on transfer of such securities at 20%, as holding period of the unlisted equity shares is more than 24 months, from date of investment.

Gross Total Income: F.Y. 2018-2019:

Particulars	Amount (Rs.)
A. INCOME FROM OTHER SOURCES	
Dividend Income	3,50,00,000
Less: 20% Deduction for Interest Expenditure	70,00,000
Gross Total Income	**2,80,00,000**

Computation of Tax Liability: F.Y. 2018-2019:

Particulars	Amount (Rs.)
Gross Total Income	**2,80,00,000**
Tax Rate @ 30%	84,00,000
Add: Surcharge @ 25%	21,00,000
Add: Health &Education Cess @ 4%	4,20,000
Total Tax Payable	**1,09,20,000**

Notes:

- Dividend Income received during the year is taxable as 'Income from Other Sources' as the income earned from sale of investments is treated as 'Capital Gains'. Dividend Collection Costs are not deductible and tax will be paid at Maximum Marginal Rate of 30%, by Fund TI. However, interest expenditure, to the extent of 20% of the total dividend income, is allowed as a deduction.

- Surcharge for F.Y. 2018-2019 will be applicable at 25%, as the income of Fund TI, excluding Capital Gains under sections 112A and 111A, is above Rs. 2 crore and less than Rs. 5 crore.

Gross Total Income: F.Y. 2019-2020:

Particulars	Basis	Amount (Rs.)
A. CAPITAL GAINS		
Full Value of Consideration: Listed Equities		
Company ABC	50,000 shares @ Rs. 900	4,50,00,000
Company XYZ	1,00,000 shares @ Rs. 1250	12,50,00,000
Company PQC	10,00,000 shares @ Rs. 185	18,50,00,000
Company LMN	75,000 shares @ Rs. 2380	17,85,00,000
Total Consideration:		**53,35,00,000**
Less: Cost of Acquisition		47,25,00,000
Total Long Term Capital Gain [A]		**6,10,00,000**
B. INCOME FROM OTHER SOURCES		
Dividend Income		**3,80,00,000**
Less: 20% Deduction for Interest Expenditure		76,00,000

Total Dividend Income [B]		**3,04,00,000**
Gross Total Income [A+B]		**9,14,00,000**

Computation of Tax Liability: F.Y. 2019-2020:

Particulars	Amount (Rs.)
A. TAX ON CAPITAL GAINS	
Total Long Term Capital Gains	6,10,00,000
Tax Liability:	
Long Term Capital Gains Tax @ 10%	61,00,000
Add: Surcharge @ 15%	9,15,000
Add: Health &Education Cess @ 4%	2,80,600
Total Tax on Capital Gains [A]	**72,95,600**
B. TAX ON OTHER INCOME	
Total Dividend Income	3,04,00,000
Tax Liability:	
Tax Rate @ 30%	91,20,000
Add: Surcharge @ 25%	22,80,000
Add: Health &Education Cess @ 4%	4,56,000
Total Tax on Other Income [B]	**1,18,56,000**
Total Tax Payable [A+ B]	**1,91,51,600**

Notes:

- Other fixed costs such as Management Fees, Fixed Yearly Expenses and Performance Fees are not deductible, for the purpose of computing capital gains, under Section 14A of the Income Tax Act. However, the tax rates for 'Capital Gains' are lower as compared to the maximum marginal rate charged for income characterized as 'Profits and Gains from Business and Profession'.

- Securities Transaction Tax (STT) would be paid by Fund TI at the time of sale of listed equity shares, at the rate of 0.1% on the transaction value of such sale. The STT paid at the time of purchase of listed shares, in F.Y. 2018-1019 and the STT paid at the time of transfer of such shares in F.Y. 2019-2020 are not eligible to be added to the Cost of

Acquisition of the securities. Any expenditure incurred in connection with such transfer, such as Brokerage Charges, would be eligible for a deduction from the sales consideration.

- The enhanced surcharge of 37% is not applicable on income chargeable under Section 112A, i.e. long-term capital gain on sale of equity shares by paying applicable Securities Transaction Tax (STT). The surcharge applicable is 15% and Health and Education Cess is levied at the rate of 4% on the amount of income-tax plus surcharge.

- Surcharge applicable on Dividend Income will be at 25%, as the income of Fund TI, excluding Capital Gains under sections 112A and 111A, is above Rs. 2 crore and less than Rs. 5 crore.

Gross Total Income: F.Y. 2020-2021:

Particulars	Basis	Amount (Rs.)
A. CAPITAL GAINS		
Full Value of Consideration: Listed Equities		
Company SME	1,50,000 shares @ Rs. 195	2,92,50,000
Company AEC	10,00,000 shares @ Rs. 130	13,00,00,000
Total Consideration:		**15,92,50,000**
Less: Cost of Acquisition		12,22,50,000
Total Long Term Capital Gain [A]		**3,70,00,000**
B. INCOME FROM OTHER SOURCES		
Dividend Income		**3,95,00,000**
Less: 20% Deduction for Interest Expenditure		79,00,000
Total Dividend Income [B]		**3,16,00,000**
Gross Total Income [A+B]		**6,86,00,000**

Computation of Tax Liability: F.Y. 2020-2021:

Particulars	Amount (Rs.)
A. TAX ON CAPITAL GAINS	
Total Long Term Capital Gains	3,70,00,000
Tax Liability:	

Long Term Capital Gains Tax @ 10%	37,00,000
Add: Surcharge @ 15%	5,55,000
Add: Health &Education Cess @ 4%	1,70,200
Total Tax on Capital Gains [A]	**44,25,200**
B. TAX ON OTHER INCOME	
Total Dividend Income	3,16,00,000
Tax Liability:	
Tax Rate @ 30%	94,80,000
Add: Surcharge @ 25%	23,70,000
Add: Health &Education Cess @ 4%	4,74,000
Total Tax on Other Income [B]	**1,23,24,000**
Total Tax Payable [A+B]	**1,67,49,200**

Notes:

- Securities Transaction Tax (STT) would be paid by Fund TI at the time of sale of listed equity shares of Company SME and Company AEC, at the rate of 0.1% on the transaction value of such sale. The STT paid at the time of purchase of unlisted shares, in F.Y. 2018-2019 and the STT paid at the time of transfer of such shares in F.Y. 2020-2021 are not eligible to be added to the Cost of Acquisition of the securities.

- The enhanced surcharge of 37% is not applicable on income chargeable under Section 112A, i.e. long-term capital gain on sale of equity shares by paying applicable Securities Transaction Tax (STT). The surcharge applicable is 15% and Health and Education Cess is levied at the rate of 4% on the amount of income-tax plus surcharge.
- Surcharge applicable on Dividend Income will be at 25%, as the income of Fund TI, excluding Capital Gains under sections 112A and 111A, is above Rs. 2 crore and less than Rs. 5 crore.

- It can be observed that Fund TI has sold its investment in Company AEC and Company SME after serving a six-month lock-in period applicable under the provisions of SEBI (Issue of Capital and Disclosure Requirements) Regulations, 2018.

- On a deeper analysis, we can conclude that Incentive Fees will not be payable to the Investment Manager, even if a miniscule hurdle rate of 8% is applied to the Net AUM of the fund, after deducting the fixed expenses and management fees. This is irrespective of the income being treated as ‘Profits and Gains from Business or Profession’ or ‘Capital Gains’.

9.4 Goods and Services Tax

A Category III AIF investment manager charges Management Fees, in return of the Investment Management services offered to the unit holders in the Fund. Such services fall under the definition of “Supply”, as per Section 7 of the CGST Act, 2017, as “Investment Advisory & Management Services”.[138] Goods and Services Tax (GST) is payable at the rate of 18% on such fees.

GST is also levied on the Trusteeship Fees, payable to the Trustee of the Category III AIF, at the rate of 18%. Further, GST is also chargeable on services provided by external 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 as “Financial and related Services”, at the rate of 18%.

GST is payable by the Category III AIF and is eligible to receive input credits for the GST paid, on its output GST Liability. However, considering the nature of business of a Category III AIF as a pooled investment vehicle, the fund has no output GST liability and, therefore, unable to obtain any benefit of input tax credits for GST paid on Management Fees, Trusteeship Fees and other input services availed by the fund. This results in an incremental cost for the Category III AIF, which is indirectly borne by the investors.

Category III AIFs operating from IFSC are exempt from GST, which enables them to offer a competent investment platform to foreign portfolio investors, similar to other popular off-shore destinations.

Under the current GST regime, a Category III AIF that pools capital from foreign investors at an offshore location, in order to invest in India, does not pay GST on the management fees. Management Fees charged by such off-shore Category III AIFs are treated as “export of services”, which is exempt from GST. However, in case of Category III AIFs, domiciled in India and pooling capital from overseas investors, GST on management fees is payable. For foreign investors in such Category III AIFs, this also violates the principle of destination-based consumption tax. As a result, foreign investors willing to invest in Indian markets through the AIF route would prefer to invest in an offshore Category III AIF or a ‘hedge fund’, on account of lower tax liabilities of the fund set-up in offshore jurisdictions.

On account of such inconsistency in the GST liabilities of Category III AIFs domiciled in India and off-shore AIFs, the Alternative Investment Policy Advisory Committee (AIPAC) formed by SEBI, has provided the following recommendations to enhance pooling of funds in Indian AIFs:

- AIFs which have a 100% foreign investment, excluding the domestic sponsor commitments, and locating their fund management operations in India should be

[138] These services are classified under Heading 997153 as per Notification 11/2017 – CGST (Rate), dated June 28, 2017.

exempt from GST. Services provided by the investment manager are completely consumed outside India, thus qualifying as 'export of services'.

- AIFs that have at least 50% foreign investments can qualify for a zero rate of GST or a lower rate of GST, such as 5%. This can encourage investment managers to set-up an AIF in India and promote on-shoring of funds.

Management Fees and fixed fees payable by the Category III AIF are subject to GST. However, the present GST regime is silent on the chargeability of GST on the 'Additional Returns' or 'Preferred Returns' accrued to the Fund. A Category III AIF is liable to pay Performance Fees on such returns to the Investment Manager. Performance Fees are payable as a compensation for additional returns generated by the investment manager and not in return for any service provided by the investment manager. Hence, such Additional Returns should be taxed as long-term capital gains accrued to the Category III AIF, as they are a reward for taking the market risks. In the case of a partnership firm or Limited Liability Partnership (LLP), the levy of GST is not attracted on distributions of profits by such firm, or LLP, to its partners. Globally as well, distribution of profits by partnership firm, or LLP, to its partners is outside the purview of GST.

Section 89(1) of the CGST Act casts a joint and several liability on all directors of a private limited company which defaults in payment of GST, including interest or penalty thereon. Such liability is however not triggered, if the director proves that the non-recovery of taxes, interest or penalty cannot be attributed to any gross negligence, misfeasance or breach of duty of the director.

9.5 Taxation on distribution/ redemption of units by Category III AIFs

A Category III AIF, through its Trustee, shall discharge its tax liabilities in respect of the income earned by the Fund, in the capacity of a 'representative assessee' of the unit holders or investors or beneficiaries in the Fund. Once the tax liabilities have been discharged by the Trustee of the fund, no further tax is payable by the unit holders, on the post-tax income distributions. This avoids double taxation of the same source of income earned by the fund. However, any early redemption of units of the Category III AIF, by a unit holder, may be treated as a separate taxable transfer. In such an event, the redeeming unit holder may be subject to tax on such redemption in addition to the tax liability discharged by the Category III AIF.

As per Section 94(1) of the Income Tax Act, 1961, if an investor sells or transfers the units of a Category III AIF and reacquires the same units after a period of time, then any interest, dividend or other such apportioned income attributable to such units would be deemed to be the income of the investor.

Corporate beneficiaries are subject to the provisions of Minimum Alternate Tax (MAT) contained in Section 115JB of the Income Tax Act, 1961. Hence, corporate beneficiaries may be liable to pay an additional tax on the distributions received from a Category III AIF, if the tax amount calculated at the rate of 18.5% (plus applicable surcharge and health and education cess) of the book profits is higher than the tax amount calculated as per the Income Tax Act, 1961.

A Category III AIF is liable to deduct 'tax deducted at source' (TDS) on distributions made to its unit holders, as per provisions of the Income Tax Act, 1961. The unit holders can claim refund of such TDS deductions from their taxable income, in their income tax return. Any distribution of income made by an 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 Income Tax Act, 1961. An AIF is liable to deduct at the rate of:

- 10%, at the time of credit or at the time of payment of such income, whichever is earlier, to the account of a 'resident investor' or a 'domestic company'.
- 20%, at the time of credit of such income to the account of a resident investor who does not quote a Permanent Account Number (PAN) to the fund.
- 30%, at the time of credit or at the time of payment of such income, whichever is earlier, to the account of a 'non-resident investor'. This amount shall be increased by the applicable Surcharge for such investor, along-with 4% Health and Education Cess.
- 40%, at the time of credit or at the time of payment of such income, whichever is earlier, to the account of a 'foreign company'. This amount shall be increased by the applicable Surcharge for such investor, along-with 4% Health and Education Cess.

As per Section 195(3), a non-resident investor can make an application to the Assessing Officer, for the grant of a certificate which authorizes such investor to receive income from the AIF, without deduction of withholding taxes or deduction at a lower rate. Alternatively, a non-resident investor can submit a Certificate issued by a Chartered Accountant, which determines the chargeability of withholding tax, on income earned by the non-resident investor. Upon submission of above Certificate(s) by the non-resident investor, the AIF is responsible to make payments to the non-resident investor, without deducting tax or deducting tax at a lower rate as stated in the Certificate.

Example 2: Withholding Taxes

Fund WT was launched in the year 2016, as an Irrevocable, Determinate Trust, with an aim to primarily make equity investments and debt investments:

Particulars	Amount
Committed Capital	Rs. 60,00,00,000
No. of units issued	6,00,000
NAV (Rs.)	1000.00

The following table provides details of income and expenses for Fund WT, during the years.

Particulars	F.Y. 2018-2019	F.Y. 2019-2020	F.Y. 2020-2021
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 @ 2% (including GST)	1,53,80,000	1,59,35,000	1,65,20,000
Fixed Yearly Expenses	25,00,000	25,00,000	25,00,000

Distribution of interest income from debentures is made on a yearly basis to the investors.

The NAV of the fund, at the end of financial year 2020-2021 is Rs.1195.00 and investors redeem all the units, as on March 31, 2021.

Compute the tax deducted by Fund WT, on distributions made in all three financial years.

Solution:

Any distribution of income made by a Category III 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. 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.

Computation of Withholding Tax on Distributions:

Particulars	F.Y. 2018-2019	F.Y. 2019-2020	F.Y. 2020-2021
Distributions:			
Interest Income, on yearly basis	1,95,00,000	1,95,00,000	1,95,00,000
Distributions to investors at liquidation (6,00,000 units)	-	-	71,70,00,000
Yearly Gross Distributions	**1,95,00,000**	**1,95,00,000**	**73,65,00,000**
Less: Withholding Tax @ 10%	19,50,000	19,50,000	7,36,50,000
Yearly Net Distributions	**1,75,50,000**	**1,75,50,000**	**66,28,50,000**

Notes:

- Section 194LBB of the Act is applicable at the time of credit of such income to the account, or at the time of payment, to a residential investor. It is assumed that Fund WT has all residential investors, to compute withholding requirements of the fund.

  Fund WT has a liability to withhold tax, at the time of crediting income to the account of investors. It is assumed that Dividend Income and Appreciation in the value of Investments is reinvested in the Fund and not credited to the account of the investors. This may be done prudently by the investment manager in order to make payment of yearly fixed expenses like management fees and fixed yearly expenses, as well as to re-invest funds based on the investment strategy of the fund.

- **Applicability of Tax on Distributed Profits of Domestic Companies**

Finance Act, 2020 has withdrawn Section 115-O of the Income Tax Act, 1961. Hence, from April 1, 2020, domestic companies are not liable to pay Dividend Distribution Tax (DDT) on dividends declared out of accumulated profits. A Category III AIF receiving dividend from a domestic company shall be liable to pay tax on such dividend income, either as ‘Profits and Gains from Business or Profession’ or as ‘Income from Other Sources’.

Similarly, dividends distributed by a Company, having units set-up in an IFSC, is not liable to pay DDT on dividends declared out of accumulated profits or current profits.

- **Applicability of General Anti-Avoidance Rule**

General Anti-Avoidance Rule (GAAR) is an anti-tax avoidance law, introduced in Chapter X-A of the Income Tax Act, 1961. GAAR may be invoked by the Indian income-tax authorities, in case any arrangements entered into by a Category III AIF are found to be impermissible avoidance arrangements. Provisions under this section are applicable from financial year 2017-2018 and will not be applicable to income accruing, arising or received from transfer of investments made before April 1, 2017.

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 tests mentioned below:

  - The transaction provides rights or obligations which are ordinarily not created between parties dealing at arm's length;
  - The transaction results in direct or indirect misuse, or abuse, of Income Tax Act;
  - The transaction lacks commercial substance or is deemed to lack commercial substance in whole or in part;
  - The transaction is entered into, or carried out in a manner, which is not normally employed for bona fide business purposes.

In such cases, tax authorities are empowered to reallocate the income from such arrangement or re- characterise or disregard the arrangement, in the following manner:

  - Dis-regarding, combining or re-characterising any step or party to transaction;
  - Ignoring the arrangement for the purpose of taxation law;
  - Deeming connected persons, in relation to each other, to be one person for the purposes of determining tax treatment of any amount
  - Relocating place of residence of a party, or location of a transaction or site of an asset, to a place other than provided in the arrangement;
  - Looking through the arrangement by disregarding any corporate structure; or
  - Re-characterising equity into debt or capital into revenue

In case the GAAR provisions are invoked, then any treaty benefits under a Double Tax Avoidance Agreement (DTAA) could be denied. This could result in any tax benefit being denied, shifting of residency of investors or re-characterization of capital gains income as any other classification.

The CBDT has clarified that GAAR will not interplay with the right of a taxpayer to select or choose the method of implementing a transaction. Further, CBDT has issued clarifications on implementation of GAAR provisions, as under:[139]

- GAAR shall not be invoked merely on the ground that an entity is located in a tax efficient jurisdiction.
- GAAR shall not be invoked in case tax avoidance is sufficiently addressed by the Limitation of Benefit Clause (LOB) in a Treaty with other countries.

9.6 Taxation on transfer of Category III AIF units by investors

The process for transfer of units should be clearly stated by a Category III AIF in the Private Placement Memorandum (PPM) to provide a mechanism for investors to transfer units before the end of the Fund's life. Gains arising on account of a transfer of units of the fund, from one investor to another, are subject to income tax in the hands of the investor initiating such transfer.

Section 45 of the Income Tax Act, 1961, provides that any profits or gains arising from the transfer of a 'Capital Asset' will be chargeable to income-tax under the head 'Capital Gains'. For our purpose of understanding taxation on transfer of units of a Category III AIF:

'Transfer' as per Section 2(47), includes 'sale' or 'exchange' of a capital asset.

'Capital Asset' as per section 2(14), includes units of an 'equity-oriented investment fund' or units of funds listed on a recognized stock exchange.

'Equity-oriented investment fund' as per Chapter 97 of the Income Tax Act, 1961, means a fund which has been set-up under a scheme of a Mutual Fund and at least 65 percent of the total proceeds of the fund are invested in equity shares of domestic companies. Percentage of equity shareholding of the fund shall be computed with reference to the annual average of the monthly averages of the opening and closing NAV of the Fund.

However, the definition of 'Capital Asset', as per the Income Tax Act, 1961, does not include 'Category III AIFs', for the purpose of computing the profits or gains arising from the transfer of units of such funds. With a view to bring clarity and compute Capital Gains on transfer of units of a Category III AIF, the SEBI AIPAC recommended the following addition to the definition of an equity-oriented investment fund.

'Equity-oriented investment fund' means an investment fund, which has been granted a certificate of registration as a Category III Alternative Investment Fund and is regulated under the SEBI (Alternative Investment Funds) Regulations, 2012.

[139]Vide CBDT Circular No. 7 of 2017 dated January 27, 2017.

- in case a Category III AIF invests in units of another fund, traded on a recognized stock exchange in India:
  - a minimum of 90 percent of total proceeds of the Category III AIF is invested in the units of such other fund; and
  - investee fund(s) also invest a minimum of 90 percent of its total proceeds in equity shares of domestic companies, listed on a recognized stock exchange in India;
- in any other case, investable funds are invested in equity shares of domestic companies listed on a recognized stock exchange in India to the extent of more than 65 percent of the total proceeds of such fund.

Percentage of equity shareholding of the Category III AIF shall be computed with reference to the annual average of the monthly averages of the opening and closing NAV of the Fund.

The Income Tax Act, 1961 provides for a mechanism for computation of income under the 'capital gains' head. Capital gains or losses are to be computed in the following manner:

Full Value of Consideration:	**XXX**
Less: Cost of Acquisition	(XXX)
Less: Cost of Improvement incurred in relation to the asset transferred	(XXX)
Less: Expenditure incurred wholly and exclusively in connection with the transfer of the asset.	(XXX)
Long Term Capital Gain / Short Term Capital Gain:	**XXX**

The rate at which capital gain tax is charged depends on the nature of the Category III AIF and the types of investments made by such fund. If the Category III AIF is classified as an 'equity-oriented investment fund', then any profits arising from transfer of units of such fund are taxable at the rate of 15% in case of short-term capital gains, and 10% in case of long-term capital gains. Similarly, if the Category III AIF is classified as a 'non equity-oriented investment fund', then any profits arising from transfer of units of such fund are taxable at a rate of 30% in case of short-term capital gains, and 20% in case of long-term capital gains.

As per Section 14A of the Income Tax Act, any expenses incurred by the Category III AIF in managing the investments, including Management Fees, Fixed expenses and Performance Fees, shall be disallowed to be treated as expenses incurred in connection with the transfer of the asset. As per this section, no deduction is allowed in respect of expenditure incurred by the Fund, in relation to income which does not form part of the total income of the Fund. Since Capital Gains are taxed in the hands of the investors, expenditure incurred by the fund does not qualify for a deduction. Hence, investors are not given the benefit of expenses, and are directly or indirectly borne by them, in proportion of their value of investments in the fund.

- **Applicability of Stamp Duty**

Government of India has introduced the regime of uniform stamp duty rates across the country, thereby simplifying the collection process. Issue, transfer and sale of units of the

Category III AIF are subject to stamp duty. The fund operations may also include professional tax, local municipal taxes or Securities Transaction Tax (STT), for any operations conducted on listed securities.

The Finance Act, 2019 has made certain amendments in the Indian Stamp Act, 1899 whereby stamp duty shall be levied as follows, on relevant investments for Category III AIFs:

1. On derivatives i.e. futures, options, currency and interest rate derivatives and other derivatives, government securities, repo on corporate bonds;
2. On transfer of securities through demat form and units;
3. On transfer of listed securities (on-market or off-market), unlisted securities in demat form as well as on issue of securities;
4. On issue or transfer of shares otherwise than through a stock exchange or a depository;
5. On all kinds of debentures as defined in section 2(10A) of the Indian Stamp Act, 1899.

The Central Government has notified the Registrars to Issue and / or Share Transfer Agents (RTAs) to act as collecting agents.[140] In this regard SEBI has also issued a circular stating that RTAs shall collect stamp duty on issue, transfer and sale of units of AIFs.[141]

Example 3: Capital Gains on Transfer of units of a Category III AIF

Let us take the example of Fund TM, to understand the applicability of capital gains on transfer of units by investors.

Fund TM was launched in the year 2017, as an Irrevocable, Determinate Trust, with an aim to primarily make equity investments and debt investments only. Fund Expiry is on March 31, 2021.

Particulars	Amount
Committed Capital (Rs.)	60,00,00,000
No. of units issued	6,00,000
NAV (Rs.)	1000.00

The fund has issued the below-mentioned class of units:

Class of Units	No. of Units	Price (NAV)	Commitment (Rs.)
Class A Units	3,00,000	1000.00	30,00,00,000.00
Class B Units	1,50,000	1000.00	15,00,00,000.00
Class F Units	1,50,000	1000.00	15,00,00,000.00
Total Capital Commitments	**6,00,000**		**60,00,00,000.00**

[140] The 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.

[141] SEBI 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.

On April 15, 2020, the investors in Class B units transfer the units to new Class C units, at an NAV of Rs. 1150.00 per unit. The fund was liquidated on March 31, 2021 by making distributions to all its investors at a NAV of Rs. 1225 per unit.

Compute the capital gains payable by all the investors in the fund, during the life of the fund and at the expiry of the term of the fund.

Solution:

All class of units have different holding periods. As per section 45 of the Income Tax Act, if units of an 'equity-oriented investment fund' are held for more than 12 months immediately preceding the date of its transfer, any gain from the sale of such units is classified as a 'Long Term Capital Gain'. For the purpose of this example, it is assumed that Fund TM is classified as an 'equity-oriented investment fund'.

Computation of Holding Period for all Class of Units:

Class of Units	**Period of Holding**	**Term**
Class A Units	April 01, 2017 to March 31, 2021	Long-term
Class B Units	April 01, 2017 to April 15, 2020	Long-term
Class F Units	April 01, 2017 to March 31, 2021	Long-term
Class C Units	April 15, 2020 to March 31, 2021	Short-term

In view of the above, Class C unit investors will be liable to pay 'short-term capital gain tax', on transfer of units of Fund TI, at 15%, as holding period of the units is less than 12 months, from the date of investment. Similarly, all other investors will be liable to pay 'long-term capital gain tax', on transfer of units of Fund TI, at 10%, as holding period of the units is more than 12 months, from the date of investment.

Computation of Long-Term Capital Gains and Tax Liability: Class A, B and F Units

Particulars	**Amounts (Rs.)**		
	Class B Units	**Class A Units**	**Class F Units**
Full Value of Consideration: Class B Units:1,50,000 units of Fund TI sold @ Rs. 1150 per unit Class A Units: 3,00,000 units of Fund TI sold @ Rs. 1225 per unit Class F Units: 1,50,000 units of Fund TI sold @ Rs. 1225 per unit	17,25,00,000	36,75,00,000	18,37,50,000
Less: Cost of Acquisition	(15,00,00,000)	(30,00,00,000)	(15,00,00,000)

Particulars	Amounts (Rs.)		
	Class B Units	Class A Units	Class F Units
@ Rs. 1000 per unit			
Long Term Capital Gain	**2,25,00,000**	**6,75,00,000**	**3,37,50,000**
Tax on Capital Gains			
Long Term Capital Gains Tax @ 10%	22,50,000	67,50,000	33,75,000
Add: Surcharge @ 15%	3,37,500	10,12,500	5,06,250
Add: Health & Education Cess @ 4%	1,03,500	3,10,500	1,55,250
Total Long Term Capital Gains Tax	**26,91,000**	**80,73,000**	**40,36,500**

Computation of Short Term Capital Gains and Tax Liability: Class C Units

Particulars	Amount (Rs.)
Full Value of Consideration:	
1,50,000 units of Fund TI sold @ Rs. 1225 per unit	18,37,50,000
Less: Cost of Acquisition @ Rs. 1150 per unit	17,25,00,000
Short Term Capital Gain	**1,12,50,000**
Tax on Capital Gains	
Short Term Capital Gains Tax @ 15%	16,87,500
Add: Surcharge @ 15%	2,53,125
Add: Cess @ 4%	77,625
Total Short Term Capital Gains Tax	**20,18,250**

In the secondary market, investors may transfer the units of a Category III AIF by paying a stamp duty of 0.015%, whether listed on a stock exchange or not. Due to multiple secondary transfers, it is likely that the composition of the pool of investors may change from time to time for the AIF, such as:

- o The investors at the time of making investments, by a Category III AIF may be different from investors at the time of earning/receiving income, by the fund.
- o The investors at the time of earning/receiving income, by the Category III AIF may be different from the investors at the time of distribution of income by the fund.

Example 4: Tax Basis Step-up Method

- January 20, 2020 - Mr. X has subscribed to 10,00,000 units of a Category III AIF – Fund A at a NAV of Rs. 500 per unit.
- January 31, 2020 - Fund A has subscribed to an unlisted debenture of PM Ltd., with 12% coupon and market rate of Rs. 100. The investment is worth Rs. 5 crore.
- March 31, 2020 - Fund A receives two-month interest of Rs. 2 per debenture, totalling to Rs. 10 lakhs.
- April 02, 2020 - Mr. X transfers the units to Mr. Y, at a NAV of Rs. 550 per unit.

- April 05, 2020 - Fund A distributes total interest income, attributable to 10,00,000 units, to the incoming unit holder, Mr. Y.
- March 15, 2021 - Fund A sells the investments in debentures at Rs. 125.

Analyse the investment returns and taxability of income for each unit holder in Fund A.

Solution:

- As per section 194LBB, Fund A will withhold tax at the time of accrual of interest income to the unitholder – Mr. X. Fund A deducts tax at 10% on interest received, in the hands of Mr. X. However, the interest was not actually distributed to Mr. X.

- Income distribution is made to the new unit-holder - Mr. Y, who is liable to pay tax on the interest income received, at the relevant slab rate.

- The fund has sold the debentures in less than 36 months from the date of purchase. Hence, short-term capital gains is payable on the sale transaction, at the hands of Mr. Y, as per Section 10 (23FBA) of the Income Tax Act, 1961.

- Tax on Short-term capital gains is payable by Mr. Y at 42.744%, assuming annual income of Mr. Y is above Rs. 5 crore, in Financial Year 2020-2021.The concessional rate of Surcharge, under section 111A will not apply in this case, as Fund A has invested in unlisted debentures.

- Tax is paid on total gain of Rs. 12.50 crore (i.e. Rs. 62.50 crore – Rs. 50 crore) which amounts to Rs. 5.34 crore. In comparison, the total investment made by Mr. Y was Rs. 55 crore. In this scenario, Mr. Y would have to suffer a loss on the specific investment made by Fund A in the debenture, instead of earning interest for the financial year.

As seen above, the incoming investor in the Fund is at a tax-disadvantage, with a risk of potential tax payments on income generated by the fund. Moreover, the exiting investor is also at a disadvantage, as withholding taxes are deducted by the Fund for income not distributed to such investor. In order to avoid this, a Category III AIF is recommended to follow a 'tax basis step-up' method to value its securities, on the date of the transfer of interest to the incoming investor, on fair value basis. SEBI Alternative Investment Policy Advisory Committee (AIPAC) has suggested implementation of this valuation method, in its final recommendation report submitted to SEBI.

Using the tax basis step-up method, the Category III AIF will value every security in the portfolio at the fair value on those dates when a new investor is investing in the fund. This fair value will be taken as the base value of investment for purpose of capital gains, for the incoming investor, who shall then pay taxes on any capital gains on the increase in value of the security, over and above the base value. This reduces the tax anomalies and increases transparency for all individuals in the Category III AIF.

Let us continue the illustration of Fund A:

- In this illustration, we assume that Fund A had taken the fair value of the debenture on April 2, 2020, which is the date of transfer of units to the new investor, Mr. Y.

- The value as on April 2, 2020 was Rs. 110, considering the NAV of Rs. 550 per unit.

- In this case, the short term capital gain tax payable by Mr. Y would be on total gain of Rs. 7.50 crore (i.e. Rs. 62.50 crore – Rs.55 crore) which amounts to Rs. 3.21 crore.

- This reduces the tax liability of Mr. Y by Rs. 2.13 crore, in the year he earns Capital Gains on transfer of the units of Fund A, i.e. Financial Year 2020-2021.

As seen above, the base value taken for the purpose of computing capital gains for the incoming investor, Mr. Y, is the fair value of the security as on the date of transfer of units of the Category III AIF by Mr. X.

9.7 Tax applicability to Category III AIFs in IFSC

An IFSC is formed with the objective to encourage foreign investors to invest in Indian AIFs and facilitate financial services and transactions in India, which are currently being carried out by overseas financial institutions or overseas branches of Indian financial institutions, in international financial hubs like Singapore, Dubai, Hong Kong, London, Ireland, Luxemburg, Mauritius, among others. The Central Government and Ministry of Finance have implemented multiple reforms to promote AIFs being set-up in an IFSC. At present, India has an IFSC, which is the Gujarat International Finance Tech-City (GIFT City) in Gujarat. The GIFT City provides a favourable business environment for Category III AIFs domiciled in the IFSC, with easy access to capital pools, state-of-art infrastructure and transportation facilities, growth-oriented regulatory reforms, availability of human capital and macro-economic stability.

The IFSCA, headquartered at GIFT City, Gandhinagar, has been established on April 27, 2020 under the International Financial Services Centres Authority Act, 2019. The IFSCA is a unified authority for the development and regulation of financial products, financial services and financial institutions in the IFSC in India. It plays a crucial role of a unified regulator, to promote ease of doing business in the IFSC and provide a world-class regulatory environment.

The International Financial Services Centres Authority has made the International Financial Services Centres Authority (Fund Management) Regulations, 2022 to regulate fund management entities, such as a Category III AIF, as per the Finance Act, 2023.

Indirect Tax Regime:

Category III AIFs operating from IFSC are exempt from GST, which enables them to offer a competent investment platform to foreign portfolio investors, similar to other popular off-shore destinations. The GST payable on Management Fees and Trusteeship Fees will not be indirectly borne by the investors in the Category III AIF.

Direct Tax Regime:

Income Tax Act, 1961, imposes source-based taxation on non-residents whereby, income received or arising or deemed to be received or arising to a non-resident in India would be subject to tax in India. Therefore, income received by a non-resident becomes chargeable to tax either when it is 'received' or is 'deemed to be received' in India by such non-resident or when it 'accrues' or 'arises' or is 'deemed to accrue or arise' to him in India during the previous year.

When a Category III AIF receives investments from a non-resident investor, and uses such capital contributions to make overseas investments, the income so generated could be deemed to be a direct investment by a non-resident, and hence not subject to tax in India. In this regard, the CBDT clarified that such income received by non-residents from offshore investments made through Category I AIFs and Category II AIFs would not be subject to tax in India. This exemption has now been extended to Category III AIFs set-up in an IFSC. Foreign Investors earning capital gains from the transfer of overseas investments, made by a Category III AIF set-up in an IFSC, is exempt from tax.

As per the provisions of GAAR, an off-shore investment structure or off-shore transaction could be deemed impermissible, and hence chargeable to tax. CBDT has clarified that GAAR shall not be invoked merely on the ground that an entity is located in a tax efficient jurisdiction. This encourages Category III AIFs to establish offices in IFSCs and attract capital commitments from foreign investors and domestic investors.

The Direct Tax regime for Category III AIFs located in an IFSC is similar to the tax regime for other Category III AIFs, with the following additional benefits being extended to such AIFs:

- **Tax holiday under Section 80LA:**

Any unit of a Category III AIF set-up in an IFSC can avail a 100% deduction from the Gross Total Income arising from activities as an AIF, for any 10 consecutive years out of a period of 15 years, beginning with the year in which the requisite permission for the operation of the fund was obtained

- **Lower rates of Minimum Alternate Tax (MAT):**

MAT is applicable at the rate of 9%, as opposed to the general rate of 18.5%, in case of units of a Category III AIF located in an IFSC, deriving its income solely in convertible foreign exchange.

- **Exemption from Securities Transaction Tax (STT):**

A transaction undertaken on a recognised stock exchange in an IFSC shall be exempt from STT, and shall be eligible for taxation at concessional tax rates for short-term capital gains, under Section 111A, and for long-term capital gains, under Section 112A.

- **Tax Benefits under the Taxation Act, 2020:**

The Taxation and Other Laws (Relaxation and Amendment of Certain Provisions) Act, 2020 (Taxation Act, 2020) provides certain relaxations in the Income Tax provisions applicable to Category III AIFs, if:

- The Category III AIF is located in an IFSC and registered with SEBI as per the provisions of the SEBI (Alternative Investment Funds) Regulations, 2012
- The Category III AIF is formed as a Trust, Company or a Limited Liability Partnership
- The Category III AIF has obtained a Certificate of Registration as a Foreign Portfolio Investor, under the SEBI (Foreign Portfolio Investors) Regulations, 2019. This is mandatory as the Category III AIF is considered as a 'person resident outside India'. Investments made by such Category III AIF are subject to the investment restrictions applicable to Foreign Portfolio Investors.
- All units issued by the Category III AIF are held by non-resident investors, other than units held by the investment manager and sponsor of the fund.

The following tax benefits are provided to Category III AIFs located in an IFSC, as per the Taxation Act, 2020:

The Taxation Act, 2020 provides exemptions to a Category III AIF located in IFSC, on the following sources of income:

- Any income accrued, arisen to, or received as a result of transfer of securities, other than shares of an Indian company. Thus, gains on transfer of derivatives or debt securities or offshore securities shall be exempt.
- Any income received from transfer of debt securities or derivatives issued by Indian companies, irrespective of whether such securities are listed on a stock exchange located in IFSC.
- Any income received from transfer of securities, held in the form of overseas investments.

Exemption on Income received from a Securitization Trust under 'Profits and Gains from Business and Profession':

Any income received by a Category III AIF located in an IFSC, from a Securitization Trust under 'Profits and Gains from Business and Profession' is exempt from tax, to the extent such income is attributable to units held by non-residents.

Exemptions to Unit Holders in the Category III AIF:

As per section 10(23FBC) of the Income Tax Act, 1961, any income accrued, arising to, or received by unit holders from a Category III AIF located in an IFSC or on transfer of units of such Category III AIF has been exempted from tax.

Exemption from Alternate Minimum Tax:

As per the amendment to section 115JEE of the Income Tax Act, 1961, Category III AIFs located in an IFSC, organised as Trusts or LLPs, have been exempted from the applicability of Alternate Minimum Tax provisions.

Tax Rates for Category III AIFs domiciled in an IFSC:

The Taxation Act, 2020 has amended Section 115AD of the Income Tax Act, 1961, to provide a flat rate of taxation for income earned by Category III AIFs domiciled in an IFSC and bring them at par with the tax rates applicable for Foreign Portfolio Investors. It is pertinent to note that the maximum rate of surcharge applicable on long-term capital gains, short-term capital gains, interest income and dividend income is 15%.

Table 9.2 summarizes the tax rates applicable to Category III AIFs domiciled in an IFSC:

Table9.2: Tax Rates Applicable to Category III AIFs domiciled in IFSC:

Nature of Income	Category III AIFs in IFSC (registered as FPI)[1]	Foreign Portfolio Investors (FPI)[1]
Dividend Income	10%	20%
Interest Income from: o Government Securities or Municipal Debt securities o Rupee-denominated Bonds of an Indian Company	5%	5%
Other Interest Income	10%	20%
Long-term capital gains	10%	10%
Short-term capital gains under section 111A, from: o sale of listed equity shares o units of equity-oriented mutual funds o units of business trust	15%	15%
Other Short-term capital gains	30%	30%

[1]Tax Rates are excluding applicable Surcharge and Health and Education Cess.

Withholding Obligations for Category III AIFs domiciled in an IFSC:

The Taxation Act, 2020 clarifies that the person responsible for paying any income, other than capital gains, to Category III AIFs domiciled in an IFSC, shall withhold tax at rate of 10% at the time of credit or payment, whichever is earlier. Interest income from rupee-denominated bonds, government securities or municipal debt securities referred to in Section 194LD of the Act, are subject to withholding at a reduced rate of 5%. No withholding tax is applicable on Capital Gains on transfer of securities accruing to Category III AIFs domiciled in an IFSC.

Tax Rates for Non-Resident Investors investing in Category III AIFs domiciled in an IFSC:

Any income accruing or arising to, or received from the Category III AIF domiciled in an IFSC shall be exempt from tax in the hands of investors. Any income on transfer of units in the Category III AIF shall also be exempt from tax in the hands of investors.

The surcharge on dividends earned by non-corporate FPIs, is capped at 15%. Hence, the enhanced Surcharge Rate of 25%, for foreign portfolio investors with total income above Rs. 2 crore, and 37%, for foreign portfolio investors with total income above Rs. 5 crore, is not applicable.

9.8 Tax impact on performance of Category III AIF

The choice of jurisdiction is important for a Category III AIF. As discussed above, 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.

In order to claim tax benefits under the DTAA, the non-resident investor shall obtain a Tax Residency Certificate (TRC), issued by the concerned foreign tax authorities and provide additional information or documents to the authorities, as prescribed. In this connection, the CBDT, vide its notification dated August 1, 2013, has prescribed certain information to be provided in Form No. 10F, along with the Tax Residency Certificate, if such information is not present in the concerned Tax Residency Certificate. The taxability of income of the non-resident investor, in the absence of a Tax Residency Certificate, or from a country with which India has no DTAA, would be subject to tax, as per provisions of the Income Tax Act.

India and Mauritius have a DTAA, which exempted a resident of Mauritius from paying income tax in India, on capital gains derived from the sale of shares of an Indian company. The provisions of the India-Mauritius DTAA were changed through a Protocol signed between India and Mauritius on May 10, 2016. The Protocol gave India a source-based right to tax capital gains which arise from sale of shares of an Indian resident company acquired by a Mauritian tax resident. The Protocol had provided for grandfathering of investments, making the protocol applicable to investments made on or after April 1, 2017. Hence, all existing investments up to March 31, 2017 had been grandfathered and sale or transfer of such shares beyond this date would not be subject to capital gains tax in India. The modification on capital gains taxation is limited to gains arising on sale of shares. This ensures continuity of tax benefits on sale of other instruments. The sale of debentures continues to enjoy tax benefits under the India-Mauritius DTAA, with a lower withholding tax rate of 7.5% for interest income earned by Mauritius investors from India. The withholding tax rate offered under the Mauritius DTAA is significantly lower than those rates specified in other DTAAs signed with Singapore (15%) and Netherlands (10%).

India and Singapore also signed a protocol on December 30, 2016 to amend the India-Singapore DTAA. The amendments introduced were largely to provide for source-based taxation of capital gains arising out of sale of Indian shares held by Singapore residents as opposed to residence-based taxation for the same.

India-Netherlands DTAA provides relief against capital gains tax in India. Gains arising to a Dutch resident, from sale of shares of an Indian company to non-resident buyer, would not be taxable in India. However, such gains would be taxable if a Dutch resident holds more than 10% of shares of an Indian company and the sale of shares is made to Indian residents.

The Organisation of Economic Co-operation and Development (OECD) released the Multilateral Convention to implement Treaty related measures to prevent Base Erosion and Profit Shifting (MLI). The MLI includes a "principal purpose test", wherein tax benefits under a DTAA can be denied if one of the principal purposes of an arrangement or a transaction was to, directly or indirectly, obtain tax benefit. This test is also applicable for an agent in an offshore jurisdiction, excluding an independent agent, who plays a principal role in investment management activities in such offshore jurisdiction. For this purpose, an agent shall not be considered independent, if such agent acts exclusively on behalf of one or more closely related enterprises. Hence, a Category III AIF must ensure that any tax benefits, under a DTAA, are not withdrawn on account of its Organization structure. Determining the tax jurisdiction is important for a Category III AIF, as it significantly impacts the direct tax liabilities and indirect tax liabilities, thus reducing the Net IRR or return to the investors in the Fund.

9.8.1 Pre and Post Tax Returns of a Category III AIF

Example 5: Comparison of Direct Taxes:

Fund INT was launched on February 19, 2019 in GIFT City Gujarat, to raise capital commitments worth USD 14 million from foreign investors and make investments in securities listed on a stock exchange in GIFT City. Fund Term expires on March 31, 2022.

Fund DOM was also launched on March 2, 2019 in Mumbai with a total corpus of Rs. 98 crore. This fund makes similar investments as Fund INT, in securities listed on a stock exchange in GIFT City. Fund Term expires on March 31, 2022.

Details of NAV and Units Issued: As on April 1, 2019

Particulars	Fund INT	Fund DOM
Committed Capital	USD 14,000,000	Rs. 98,00,00,000
No. of units issued	14,000	9,80,000
NAV	USD 1000	Rs. 1000
Exchange Rate	1 USD = Rs. 70.000	

Statement of Investments, as on April 1, 2019:

Particulars	Quantity	Rate	Fund DOM	Fund INT
			Amount (Rs.)	Amount ($)
Investments in Companies listed on IFSC Stock Exchange:				
Listed Equities:				
Company I	10,000	700.00	70,00,000	100,000
Company F	2,50,000	1,260.00	31,50,00,000	4,500,000
Company S	6,00,000	350.00	21,00,00,000	3,000,000
Company C	75,000	2,240.00	16,80,00,000	2,400,000
Listed Mutual Fund Units:				
Equity-oriented Scheme of Fund EQMF	20,00,000	140.00	28,00,00,000	4,000,000
Total Investments			**98,00,00,000**	**14,000,000**

On March 14, 2020:

- Fund INT sells all the units of the equity-oriented mutual fund scheme, at a Fair Value of Rs. 183.75 per unit, and receives USD 5 million from the transaction.

- Fund DOM sells all the units of the equity-oriented mutual fund scheme, at a Fair Value of Rs. 183.75 per unit, and receives Rs. 36.75 crore from the transaction net off the applicable Securities Transaction Tax, payable on sale of mutual fund units.

Compute the Tax payable on 'Capital Gains' earned by Fund INT and Fund DOM, on sale of mutual fund units. Analyse the results.

Solution:

Fund INT is set-up in an IFSC and has raised all its committed capital from foreign investors. As per Section 47(viia) of the Income Tax Act, any transfer by Fund INT of specified assets, such as Global Depository Receipts (GDRs), Rupee-denominated Bond (RDBs) of an Indian company, derivatives, units of a mutual fund or units of a business trust listed on a stock exchange located in IFSC, would not be regarded as 'transfer'. Hence, Fund INT is EXEMPT from Capital Gains arising from sale of equity-oriented units of Fund EQMF. Further, the fund has done transactions in convertible foreign currency.

Under Section 112A of the Income Tax Act, 1961, Fund DOM is liable to pay tax on Long-Term Capital Gains arising from sale of units of equity-oriented units of Fund EQMF. The concessional rate of 10% is applicable, as the units were held for more than 12 months, from the date of purchase and STT was paid on the sale transaction.

Applicable surcharge rate is 15%, as per Section 112A, and Health and Education Cess is 4%.

Computation of Capital Gains and Tax Liability - Fund INT and Fund DOM:

Particulars	Fund DOM	Fund INT
	Amount (Rs.)	Amount ($)
Full Value of Consideration:		
20,00,000 units equity-oriented scheme of Fund EQMF	36,75,00,000	5,000,000
Less: Cost of Acquisition:	28,00,00,000	4,000,000
Long Term Capital Gain	**8,75,00,000**	**1,000,000**
Tax on Capital Gains		
Tax on Long Term Capital Gains @ 10%	87,50,000	**EXEMPT**
Add: Surcharge @ 15%	13,12,500	-
Add: Cess @ 4%	4,02,500	-
Total Long Term Capital Gains Tax	**1,04,65,000**	**EXEMPT**

Fund DOM is paying Rs.1,04,65,000 in tax on 'capital gains' as the Fund is not domiciled in an IFSC, as compared to Fund INT which does not pay any tax on gains from such transfer.

9.8.2 Impact of GST on Fees

Category III 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.

Category III AIFs operating from an IFSC are exempt from GST. Hence, the fees payable to the investment manager, trustee and the external service providers, are not taxable.

Example 6: Comparison of Indirect Taxes

Fund G was launched on April 1, 2019 in GIFT City Gujarat, to raise capital commitments worth USD 14 million from foreign investors and make investments in securities listed on a stock exchange in GIFT City. Fund Term expires on March 31, 2022.

Fund N was also launched on April 1, 2019 in Mumbai with a total corpus of Rs. 98 crore. This fund makes similar investments as Fund G, in securities listed on a stock exchange in GIFT City. Fund Term expires on March 31, 2022.

Details of NAV and Units Issued: As on April 1, 2019

Particulars	Fund G	Fund N
Committed Capital	USD 14,000,000	Rs. 98,00,00,000

No. of units issued	14,000	9,80,000
NAV	USD 1000	Rs. 1000
Exchange Rate	1 USD = Rs. 70.000	

Fund G and Fund N pay 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, 2020:

Particulars	**Fund N**	**Fund G**
	Amount (Rs.)	**Amount (USD)**
Trusteeship Fees	73,50,000	1,05,000
Fund Administrator Fees	42,70,000	61,000
Custodian Fees	51,10,000	73,000
Auditor Fees	44,80,000	64,000
Legal Advisor Fees	22,40,000	32,000
Investment Advisor Fees	11,90,000	11,000

Calculate the GST payable by Fund N and Fund G for the Financial Year 2019-2020. Analyse the results.

Solution:

Calculation of Total Fees and GST Payable – Financial Year 2019-2020

Particulars	**Fund N**	**Fund G**
	Amount (Rs.)	**Amount (USD)**
Management Fees (2% of NAV, as on April 01, 2019)	1,96,00,000	280,000
Add: GST on Management Fees @ 18% **[A]**	35,28,000	EXEMPT
Total Management Fees payable	**2,31,28,000**	**280,000**
Trusteeship Fees	73,50,000	105,000
Add: GST on Management Fees @ 18% **[B]**	13,23,000	EXEMPT
Total Trusteeship Fees payable	**86,73,000**	**105,000**
Fund Administrator Fees	42,70,000	61,000
Add: GST on Management Fees @ 18% **[C]**	7,68,600	EXEMPT
Total Fund Administrator Fees payable	**50,38,600**	**61,000**

Custodian Fees	51,10,000	73,000
Add: GST on Management Fees @ 18% **[D]**	9,19,800	EXEMPT
Total Custodian Fees payable	**60,29,800**	**73,000**
Auditor Fees	44,80,000	64,000
Add: GST on Management Fees @ 18% **[E]**	8,06,400	EXEMPT
Total Auditor Fees payable	**52,86,400**	**64,000**
Legal Advisor Fees	22,40,000	32,000
Add: GST on Management Fees @ 18% **[F]**	4,03,200	EXEMPT
Total Legal Advisor Fees payable	**26,43,200**	**32,000**
Investment Advisor Fees	11,90,000	17,000
Add: GST on Management Fees @ 18% **[G]**	2,14,200	EXEMPT
Total Investment Advisors Fees payable	**14,04,200**	**17,000**
Total GST Paid by Fund [A+B+C+D+E+F+G]	**79,63,200**	**EXEMPT**
NAV as on April 01, 2019	98,00,00,000	14,000,000
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 is irrecoverable in form of input credits, thereby increasing the indirect cost for investors in the fund. However, a Category III AIF set-up in an IFSC does not have to bear the GST liability, on all input services of the fund, including Management Fees and Trusteeship Fees.

Chapter 9: Sample Questions

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. **Capital Loss, accumulated at the level of Category III AIF as on 31st March, 2019, can be deemed to be the loss of a unit holder, who has held units in the fund as on 31st March, 2019 for a minimum period of 12 months. State whether True or False.**

   a. **True**
   b. False

3. **Section 111A is applicable to the following short-term capital gains, EXCEPT:**

   a. Short-term Capital Gains on sale of equity shares listed on a recognised stock exchange, chargeable to STT.
   b. Short-term Capital Gains earned on sale of units of an equity oriented mutual fund sold through a recognised stock exchange in an IFSC, not chargeable to STT.
   c. Short-term Capital Gains earned on sale of units of an equity oriented mutual fund sold through a recognised stock exchange, chargeable to STT.
   d. **Short-term Capital Gains on sale of equity shares listed on a recognised stock exchange, not chargeable to STT.**

4. **The following types of income will most likely be taxed as 'Income from Other Sources' for a Category III AIF, EXCEPT:**

   a. Dividend Income
   b. Interest Income
   c. **Income from transactions in exchange-traded derivatives**
   d. Deemed Income on Investment in shares below its Fair Market Value, under Section 56(2)(x) of the Income Tax Act

5. **Category III AIFs operating from GIFT City need to pay GST on services received from external providers, but are exempt from charging GST on Management Fees. State whether True or False.**
   a. True
   b. **False**

Chapter 10: Good Practices

LEARNING OBJECTIVES:
After studying this chapter, you should know about: • Importance of a Pitch Book along with transparent disclosures • Role of Distributors • Good practices and code of conduct • Importance of Insurance for a Category III AIF

10.1 Fund Pitch Book – Role and Significance

Pitch Book of a Category III AIF is a confidential document prepared by the Investment Manager, containing information of the proposed scheme, profile of investment manager and investment management team, historical performance track record of the fund, if any, proposed investment strategy, investment philosophy of the manager and investment process. The pitch book is strictly meant for private circulation to proposed investors, directly investing in the fund, or to third-party distributors appointed by the investment manager.

The pitch book is prepared after a thorough analysis of the Private Placement Memorandum (PPM) issued by the Category III AIF. The Investment Manager, and the distributor appointed by such manager, should ensure that all disclosures are transparent in nature and do not contain any misleading information with respect to the fund or investment manager. Circulation of Pitch Book should be done to such high net-worth individual (HNI) investors and institutional investors, with an investment mandate to invest in Category III AIFs and seek investments if the proposed investment strategy is suitable to their risk-return objective.

An ideal pitch book of a Category III AIF should have the following transparent disclosures:

- **Introduction to the Fund Sponsor and Investment Manager:**
    - Details of Sponsor Group and Investment Manager of the Category III AIF
    - Details of the Distributor appointed by the Fund
    - Minimum Sponsor Commitment and Continuing Interest
    - Details of the Investment Management Team, with their brief profile
    - Experience of Investment Manager and previous track record, in other funds (if any)

- **Historical Performance of the Category III AIF/Fund scheme:**
    - History and track record of the fund/scheme

    - Comparison of historical performance of the fund/scheme with key market indices and relevant benchmarks, as published by Performance Benchmarking Agencies.

- **Proposed Investment Strategy of the Category III AIF/Fund scheme:**

    - Overview of target markets, sectors and current market outlook
    - Investment Objective of the fund/scheme and investment process
    - Investment Philosophy of the investment manager
    - Investment Strategy of the fund/scheme, with detailed description on target industries, types of securities for investments, target allocation, time horizon of investments and risk-return objectives of the fund
    - Leverage Strategy of the fund/scheme, with detailed description on the types of derivative exposures, target markets and inherent risks of such exposures
    - Exit Strategy during the stated fund term
    - Investment Opportunity and Expected risk-return profile of the fund/scheme, on implementation of the Investment Strategy

- **Key Terms:**

    - Fund Structure and relevant jurisdiction, if fund is an offshore fund
    - Fund Tenure
    - Target Corpus
    - Investor eligibility requirements
    - Details of capital commitments and investment period for each class of units issued to specific investors. Investor Side Letter clauses, if applicable to a specific class of units
    - Co-investments, if applicable, and Most Favoured Nation (MFN) clauses, if any
    - Dates of First Close and Final Close
    - Fee Structure, indicating Management Fees and yearly expenses chargeable to the fund/scheme. Details of Additional Returns, along-with catch-up provisions and hurdle rate applicable for each class of units
    - Key service providers and governance mechanisms
    - Investor Reporting mechanism
    - Contact Details of Investment Manager or Point of Contact at the fund

- **Key Risk Factors:**

Key risk factors should be extracted from the detailed disclosures provided in the Private Placement Memorandum (PPM) and most important risk factors applicable to the fund/scheme should be disclosed in the Pitch Book, such as:

- Risk Factors related to Portfolio Investments
- Risk Factors related to Fund Structure
- Regulatory Risk Factors
- General Risk Factors
- Tax-related Risk Factors
- Sector-specific Risk Factors
- Currency-related Risk Factors

The Distributor should be able to prepare a Sales Pitch to potential investors in the fund/scheme. The Distributors' Sales Pitch includes Product Analysis on the basis of the investment strategy of the fund/scheme, inherited costs, risks and return in the fund, product suitability of the fund based on risk profiling etc. It is advisable to maintain a Distribution Kit, with the following information and documents:

- Copies of Fund Constitution and SEBI Registration Certificate of the fund/scheme
- Private Placement Memorandum (PPM) issued by the Category III AIF
- Distributor's Investor Presentation
- Key Disclosure Statement, extracted from the PPM
- Key timelines with respect to the fund/scheme
- KYC documentation requirements, as per FEMA, PMLA and other applicable laws
- Relevant forms for investors in different constitutions and jurisdictions
- Note on Foreign Account Tax Compliance Act (FATCA) requirements and FATCA declaration forms
- Expert opinions, if any
- Essential approvals, if any, required for the investment
- FAQs on the scheme, fund, sponsor, investment manager, investment process, investor eligibility, tax laws and regulations, risk profiling and stock selection.
- Co-ordinates of key officials and relationship managers from the distributor's office

10.2 Role of Distributors – Pre-investment and Post-investment

Distributors are a vital link between Category III AIF managers and High Net-worth Individual (HNI) investors or Institutional investors. As the AIF investment community consists of large institutional investors and HNI investors, whether domestic or offshore, distributor skills and competence levels have to match up to the expectations of such informed investors.

Institutional investors prefer transparent disclosures on the performance of the Category III AIF, to help them make investment and exit decisions. Further, institutional investors need to ensure that they invest in such Category III AIFs, and in such quantum, which are suitable to their investment mandate and risk appetite. Considering Category III AIF investments may be illiquid as well as have higher market risk, investors need to analyse the investment strategy adopted by such fund and ascertain the expected return from the fund. Fee Structure and Taxation Structure of the fund also plays a vital role in the decision-making process of the investors in a Category III AIF.

Distributors have the obligation to understand and stay updated with the development in the Alternative Investments market, taxation reforms and characteristics of the Category III AIF units being distributed. This enables them to match a specific Category III AIF unit with investor profiles and their risk-appetite. Marketing, Sales, Investor Support and Relationship Management form the four pillars of AIF distributorship. As Category III AIFs have a long gestation period, till the fund expiry, a long-term engagement with investment managers and investors is crucial. This helps Distributors in generating more investment opportunities for follow-on funds or schemes launched by a Category III AIF.

The commercial arrangement between the Category III AIF and the distributor is based on marketing commissions. Distributor services are the key differentiators to establish the distributor’s activity leadership, build a clientele and relationship with Category III AIFs. The key elements of distributor services are listed below:

- **Pre-Commitment Services**

    - Engagement with investment managers to obtain information on upcoming fund/scheme launch
    - Preparation of Pitch Books and Distribution Kits
    - Engagement with institutional investors and HNI investors, wealth managers, portfolio managers, family offices, and representatives of foreign investors to organize investor meets and closed-door marketing activities
    - Presenting the Investment Strategy and introducing the fund/scheme in initial meetings with investors and soliciting investor interest
    - Explaining the key disclosures and risk factors of the fund/scheme and ascertaining the suitability of the fund/scheme for potential investors
    - Compiling additional information requirements or documents for investors and procuring the same from the investment manager
    - Facilitating Fund Due Diligence by investors
    - Seeking consent for capital commitment
    - Assisting in the transaction process and completion of related documentation

In order to provide the above-mentioned services to investors in the Category III AIF, it is essential for the distributors to stay informed and updated on the Investment Strategy, inherent Risk Factors and any changes in the Investment Strategy. Material changes made by the Investment Manager in the Investment Strategy should be informed to the Distributor. The Distributor should be obliged to inform such changes, and its potential impact on the total risk and suitability of the revised investment strategy, to every existing investor and potential investors. Material changes to the investment strategy include changes such as:

- Change in the target sectors and/or target industries
- Change in target holding period of investments and exit strategy
- Change in target allocation to various asset classes or securities
- Change in valuation methodology and policies
- Increase or decrease in target leverage, due to change in leverage strategy
- Impact on the estimated return of the fund, due to deviation in the strategy

In addition to the above-mentioned services to be provided by Distributors, before raising capital for a Category III AIF, the following services should also be provided to investors and funds, after the investments are received from investors and invested by the investment manager.

- **Post-Investment Services**

  - Interact with investors, Category III AIF and the investment manager for co-ordinating periodic capital calls and drawdown notices. The distributor should facilitate transfer of funds, incidental processes connected with each drawdown transaction and related documentation.
  - Interact with investors to get investor approval, if any, on behalf of the Category III AIF and intimate the same to the investment manager, as per the provisions of SEBI (Alternative Investment Funds) Regulations.
  - Serve as a Point of Contact (POC) for any support with respect to investor's requirements such as receipt of periodic investor reports from the investment manager.
  - Facilitate meetings between the investment manager and investors, along-with incidental procedural and administrative requirements.
  - Assist in forwarding investor requirements, with respect to co-investments and report on fund performance and investor grievances to the investment manager.
  - Marketing the follow-on fund/scheme of the Category III AIF and thereby perform the related processes with respect to marketing.

10.3 Client Confidentiality and Data Privacy at Distributor Level

The Distributors Agreement signed between the Category III AIF manager and the Distributor contains the scope of services and legal clauses, enforceable under law. One of the key clauses in the agreement is in respect to Confidentiality and Privacy of Data, relating to fund and its investors. As discussed above, pitch book is confidential to the investment manager of a Category III AIF and is meant for private circulation only. Similarly, data shared by the investment managers with respect to investment strategy, investment process, target allocations, target sectors, time horizon, fund life, expected returns, fund terms and fee structure of the fund/scheme is confidential in nature. Such data is proprietary to the Category III AIF, deemed to be owned by the fund and can be categorized as 'Financial Data' under the Data Protection Bill, 2018. Sharing of financial data would result in a breach of data privacy and confidentiality, resulting in suitable penalties and remedies under the Bill and/or as mentioned in the contract signed between the Category III AIF and Distributor.

Implementation of adequate internal controls is crucial for Distributors, considering the use of technology in every business operation. Confidentiality can be compromised by internal and external factors, such as Espionage, Cyber-crime and Data Theft. Distributors should implement an internal Confidentiality Policy, to ensuring that data of investors and investment managers is not compromised. Such Confidentiality Policy should be communicated to employees of the Distributor, including personnel in teams, inter-alia including Sales, Investor Relations, Client On-boarding, Relationship Management, Customer Service and other teams. Moreover, the policy should be made binding on all employees, including board members, partners, directors as well as third-party service providers on-boarded by the distributor on a contractual basis. The policy should provide a clear list of compulsory actions, as well as prohibited actions, in order to ensure confidentiality of data.

- **Confidentiality Measures:**

Confidential and proprietary information is secret, valuable, expensive or easily replicated.

Best practices include:

- Encryption of electronic information and safeguarding databases
- Ask employees to sign non-disclosure agreements (NDAs)
- Have Firewalls set-up, when permitting external sources to access the company server
- Take back-up of confidential data at frequent regular intervals, and store a copy of such back-up at a Disaster Recovery Site
- Store and lock paper documents
- Ask for authorization by senior management to allow employees to access certain confidential information

Employees who do not respect the Distributor's Confidentiality Policy should be held liable for disciplinary action. The employees should:

- View confidential information on secure devices
- Disclose information to other employees when it's necessary and authorized
- Not have access to portable storage devices on their personal computers
- Not have access to personal emails
- Secure confidential information, with passwords and encryptions

- Shred confidential documents, when not required
- Keep confidential documents inside within office premises, unless it's absolutely necessary to move them

The employees should not:

- Use confidential information for any personal benefit or profit
- Disclose confidential information to anyone outsider and third-party, without authorization
- Replicate confidential documents and files and store them on personal storage devices

Confidential information may occasionally be disclosed for legitimate reasons, such as:

- If a regulatory body requests it as part of an investigation or audit
- If it is required under contract, to be shared with specific third parties

In such cases, employees having access to such data should document their disclosure procedure and collect necessary authorizations.

10.4 Code of Conduct

Good practices in distribution of Category III AIFs are necessary to establish credibility, trust, reputation and global standards of excellence. This benefits the Distributors as well to establish a leadership position in the Alternative Investments eco-system. Good practices also help in meeting the regulatory intent behind the SEBI (Alternative Investment Funds) Regulations, in serving the best interests of investors investing in AIFs.

Every Distributor should formulate an Internal Code of Conduct, which should be communicated to its employees and external service providers engaged by such Distributor. The intent behind establishing the Internal Code of Conduct should be to safeguard the interests of investors and avoid unfair or fraudulent trade practices. The Code of Conduct should ensure that there is alignment of interests of investors, distributor as well as the Category III AIF issuing units, when offering distribution services to such fund. Hence, the Internal Code of Conduct should ensure that there are no conflicts of interest, when distributing units on behalf of a Category III AIF and marketing the fund/scheme to potential investors.

Model Code of Conduct for Category III AIF Distributors[142]

i. Adhere to SEBI (Alternative Investment Funds) Regulations, 2012, as amended from time to time, and circulars issued by SEBI relating to distribution, marketing,

[142] Model Code of Conduct for Category III AIF Distributors to be read along-with the Code of Conduct mentioned in SEBI (Alternative Investment Funds) Regulations.

performance benchmarking and investor reporting requirements of Category III AIFs.

ii. Be fully conversant with key provisions of PPM disclosures made by the Category III AIF, such as Investment Strategy, Fee Structure and key terms of the Contribution Agreement to be signed by an investor and the Category III AIF manager.

iii. Inform investors about the key risk factors of each fund/scheme and desist from misrepresentation or exaggeration. Encourage investors to go through the disclosures made in the PPM and all related documents of the fund/scheme before making an investment decision.

iv. Disclose all material information including Hurdle Rate, Management Fees, Additional Returns and Catch-up provisions, if any, expenses chargeable to the Fund and expenses to be borne by the investment manager.

v. Consider investor's interest, risk profiling and suitability to their financial needs while marketing Category III AIFs and advising on the same.

vi. Highlight all assumptions made by the Category III AIF in performance calculation, risk assessment and performance estimation, if any.

vii. Take necessary steps to ensure that the investors' interest is protected. Ensure that commissions or incentives on sale of Category III AIF units shall never form as the basis for recommending a fund/scheme.

viii. Disclose all material information including the details of distribution commissions to be received, on subscription to various classes of units offered by the Category III AIF.

ix. Abstain from assuring returns in any Category III AIF fund/scheme and from any kind of misrepresentation thereon.

x. Abstain from attracting investors through unethical means such as providing an offer of rebate, pass-back, gifts or other concessions.

xi. Abstain from obfuscating the decision-making process of investors, by omission of material facts or misleading investors about the fund/scheme.

xii. Maintain high standards of integrity, promptitude and fairness in the conduct of business as a Distributor.

xiii. Act with required skill, care and diligence in the conduct of business as a Distributor.

xiv. Assist clients in completing KYC documentation and verification procedures.

xv. Maintain necessary infrastructure to provide pre-commitment and post-commitment support to investors, investment manager, regulators and third-party service providers. This may include support in terms of providing intimations for draw-downs, capital calls, investor meetings, redemptions, fund-closing, investor grievances, dispatching of performance reports to investors and other important matters from time to time.

xvi. Stay updated with latest developments in the Category III AIF markets, changes in the Fund Sponsor, Investment Manager, changes in controlling interest of the fund/scheme, exit of key executives, adverse developments and other material aspects.

xvii. Maintain confidentiality of investors' personal data, deals and transactions done by a Category III AIF.

xviii. Provide relevant documents of investors to tax authorities and enforcement agencies under the Prevention of Money Laundering Act, including KYC documents, Power of Attorney (PoA), and any other information as may be required from time to time.

xix. Abstain from making negative statements about other Category III AIFs that the distributor is not representing. Ensure that comparison of Category III AIFs is done between similar and comparable Category III AIFs, based on adequate information.

xx. Not indulge in any manipulative, fraudulent or deceptive practices or spread rumours with a view to make personal gain.

10.4.1 Prohibit fraudulent and unfair trade practices

Distributors of Category III AIFs have the responsibility to protect investors from potential fraudulent activities. Unfair or fraudulent practices may be done by third-party service providers, when dealing with confidential data of investors in the fund/scheme. Direct or indirect misleading statements, concealing or omitting material facts of the fund/scheme, concealing key risk factors of the fund/scheme and not taking reasonable care to ensure suitability of the fund/scheme to the investor will be construed as a fraudulent or unfair trade practice.

Distributors should take reasonable steps to ensure that their internal staff is assisting in the documentation and KYC process, while on-boarding a new client or investor. This reduces the risk of potential fraudulent activities by third-party service providers, such as data theft, misuse of confidential data and sharing such data without seeking consent. They should be diligent in attesting investor documents and performing In-Person Verification (IPV) of investors, for the KYC process. The Distributor should also ensure that their staff is following the Internal Code of Conduct, set within the firm, and communicating all the potential violations to the Compliance Officer or Operations Officer, in the Distributor's office.

Distributors should abstain from providing incorrect or misleading information of their Organization and employees, officials or sales agents to the investor. They should abstain from tampering with investor details provided in the documentation. Distributors should also ensure that they are not in violation of SEBI (Prohibition of Fraudulent and Unfair Trade Practices relating to Securities Market) Regulations.

Category III AIFs can be 'deemed to be connected persons', as specified in the SEBI (Prohibition of Insider Trading) Regulations, and hence shall not communicate, provide or allow access to unpublished price sensitive information, except in furtherance of business purposes, performance of duties or discharge of legal obligations. Distributors should ensure that the Category III AIF is maintaining a structured digital database internally, to disclose the nature of unpublished price sensitive information shared, names of persons who have shared such information and names of persons with whom such information is shared, along with the Permanent Account Number of the recipient.

Distributors should not follow unfair practices such as extending Pass-backs to investors, who subscribe to units of a Category III AIF being marketed by such distributor. Pass-backs are an indirect incentive provided to potential investors, wherein the distributor gives back a part of the commission earned from the AIF, to the investor. This represents an inherent conflict wherein potential investors are discouraged to take investment decisions based on the merit of the fund and investment strategy implemented by the investment manager.

10.4.2 Prohibit conflict of interest

Distributors should observe high standards of ethics, integrity and fairness in its dealings with clients, inter-alia including Investors, Category III AIF and its investment manager, Custodians and other third-party service providers such as law firms, due diligence experts etc. They should render high standards of service, exercise due diligence, and ensure proper care and desist from practices that would involve conflict of professional interest or put investor interests in jeopardy.

The Distributors shall not market or sell products of a Category III AIF, wherein they have a potential conflict of interest with such fund, investment manager, employees of the investment manager, sponsor, trustee or a third-party service provider engaged by such fund. A potential conflict of interest can be created if the Distributor is a relative, associate or an affiliate or subsidiary of such fund, investment manager or sponsor, as per the SEBI (Intermediaries) Regulations.

Distributors should also abstain from entering into Soft Dollar Arrangements with investment managers. In a soft dollar arrangement, the Category III AIF may use clients' money as a medium to pay for third-party research and proprietary research. Research should be purchased with client assets, only if the primary use of such research report or service directly assists the manager in investment decision-making process and not in the management of the investment firm. Any proprietary research should be paid for from the assets of the investment manager.

Soft Dollar Arrangements can indirectly add to the cost of investment, which is indirectly borne by the investors and is a potential conflict of interest. Investment Managers must consider the capabilities of brokers appointed by the Category III AIF, to provide Best Execution for clients. Distributors should ensure that the investment manager acts as a fiduciary and disclose all benefits which the investment manager receives through a client's brokerage. Industry best practices require that Distributors should document the Soft Dollar Arrangements with Clients. The Investment Manager must disclose to the Client that the Category III AIF may engage in Soft Dollar Arrangements.

Distributors should not follow unfair practices such as extending Pass-backs to investors, as this represents an inherent conflict. Further, the Category III AIF and the investment manager should also ensure that there are no potential conflicts of interest between the Distributor and the investors. Distributors should avoid getting capital commitments from an entity which is a subsidiary, associate or affiliate of the Distributor, or an entity in which such distributor is a director or holds more than 10% of the paid-up capital. Such conflicts of interest should be avoided, especially when there are investor side letters signed between the Category III AIF and entities investing in the fund, which are affiliates, subsidiaries or associates of the Distributor. This investment represents a 'related party transaction', liable for further scrutiny under the direct tax laws.

Distributors should also ensure that they engage with such Category III AIFs which do not have potential conflicts of interests at the fund level, or such potential conflicts are disclosed in the PPM, by the investment manager. Distributors should ensure that material conflicts of interest are disclosed to all investors, before they make an investment decision. Investment Managers should prepare research reports, make investment recommendations, and take investment actions that always place the interests of the clients before the interests of the Category III AIF and its employees. The Investment Manager should have effective policies and controls in the organization, to minimize conflicts of interest which may jeopardize the independence and objectivity of research.

10.4.3 Prohibit marketing activities detrimental to investors and employees

Distributors should observe high standards of transparency and ethics, when marketing a fund/scheme of a Category III AIF. They should intimate the Category III AIF, investment manager, investors and SEBI about any changes in the distributor's status, constitution, address, contact details or any other information provided at the time of obtaining AIF distributorship. Distributors should adhere to the guidelines and other statutory requirements, as may be prescribed from time to time, related to distributors, selling, distribution and marketing practices by industry associations.

Distributors should ensure that their employees, sales team and agents follow the Internal Code of Conduct, with respect to safeguarding the interests of investors. Employees should not try to mislead potential investors, in order to secure their compensation. They should consider investor's interest and risk profiling before pitching any Category III AIF schemes.

When providing their distribution services, Distributors should abstain from assuring returns to the investors, in any Category III AIF fund/scheme. They should be conversant with key provisions of PPM disclosures made by the Category III AIF, such as Investment Strategy, Fee Structure and key terms of the Contribution Agreement to be signed by an investor and the Category III AIF investment manager. The Distribution Kit should be updated on a regular basis with necessary information and FAQs for the investors. Further, distributors should inform investors about the key risk factors of each fund/scheme and encourage investors to read the PPM and other scheme-related documents.

Distributors should ensure that they maintain confidentiality of investors' personal data, deals and transactions done by a Category III AIF. Distributors should abstain from influencing the decision-making process of investors, by omitting material facts or misleading investors about the fund/scheme. They should not extend Pass-backs to investors or enter into soft-dollar arrangements with Category III AIFs. Distributors should disclose details of distribution commissions to be received, on subscription to various classes of units offered by the Category III AIF. Similarly, distributors should abstain from making negative statements about other Category III AIFs and provide comparison of Category III AIFs, with similar fund characteristics.

10.5 Importance of Insurance for a Category III AIF

A Category III AIF is a pooled investment vehicle which invests funds in various asset classes, based on the Investment Strategy of the fund. The investment manager has a fiduciary responsibility to safeguard the funds and generate the expected returns for all classes of investors in the fund. However, the investment manager faces market risk, wherein the manager would not be able to ascertain certain factors influencing price movements in the securities market. This may be due to uncontrollable factors, specific to the country in which the fund is domiciled, or due to global macro-economic factors and social factors impacting the performance of the securities markets, at a large scale.

Investors in the fund indirectly face the market risk and risk of uncertainty in the prices of securities. If investors may not receive the expected returns due to the inefficiency or errors on behalf of the investment manager, they may file a legal suit against such Category III AIF, as per the clauses in the Contribution Agreement. In order to prevent such legal suits and the costs associated with such legal actions, the Category III AIF should purchase a 'Professional Indemnity Insurance'. Professional Indemnity Insurance protects the Category III AIF from any costs borne by such fund, as a result of a substantial loss caused to an investor due to errors and omissions in the services provided to such investor. Hence, the insurance policy is also known an 'E&O Insurance' or 'Errors and Omissions Insurance' taken by the Category III AIF to safeguard against any potential losses to investors, on account of an error or omission by the investment manager and the investment management team. It is to be noted that such insurance policy safeguards the Category III AIF, which has bought the insurance policy, against potential losses to investors.

Directors, partners and executives of the entity managing the fund, such as the Fund Sponsor and the Investment Manager, can also purchase 'D&O Liability Insurance'. Such insurance is intended to safeguard key individuals from personal losses, if they are sued as a result of serving as a director or an officer of a Category III AIF. 'D&O Insurance' claims can cover losses associated with any lawsuit filed against the directors and officers, including legal fees. However, such insurance policies do not cover claims on account of fraudulent activities of the directors and officers of the Category III AIF.

The Investment Manager is the key decision-maker for a Category III AIF, making investment decisions on behalf of the investors in the fund. Successful investment funds rely heavily on the intellect and expertise of key personnel in the fund, making investment decisions. An unexpected loss of key personnel, or key-man, of the Category III AIF is a significant risk to investors, especially if such fund is relying on a single investment manager. 'Key-man Insurance' is taken by a Category III AIF to compensate the fund for financial losses arising from the death or incapacity of a key executive, such as the investment manager. The Insurance can cover events such as 'death', 'incapacity', 'kidnap' or 'disability' of a key executive, which can significantly impact the decision-making capacity of such key executive and hence, the potential returns of the fund. Purchasing key-man insurance can give investors a comfort that the Category III AIF will be able to make orderly dissolution, in case of immediate liquidation or transition of the fund, wherein a new investment manager is appointed as part of Succession Planning. Hence, investors can be assured that they will be compensated for setbacks incurred from the loss of the key-person's services.

Key-man Insurance and Professional Indemnity Insurance, such as 'E&O Insurance' and 'D&O Liability Insurance' are important for a Category III AIF to contain losses incurred by the fund, key personnel of the fund as well as the investors, due to unpredictable factors. Distributors engaging with Category III AIFs should ascertain the risks borne by Category III AIFs, due to potential losses to investors and suggest funds to buy such insurance policies. However, the cost of the insurance premium is indirectly borne by the investors in the Category III AIF. The amount of insurance taken is typically around 1-2% of the total assets under management and covers all the entities in the Category III AIF, including the trust, fund scheme, investment manager, sponsor and settlor.

Chapter 10: Sample Questions

1. **The following are Best Practices to ensure data confidentiality, as per the Confidentiality Policy of a Distributor, EXCEPT:**

    a. Take back-up of confidential data at frequent regular intervals, and store a copy of such back-up at a Disaster Recovery Site
    b. Encryption of electronic information and safeguarding databases
    c. **Provide access to all employees to access confidential information**
    d. Ask employees to sign non-disclosure agreements (NDAs)

2. **Marketing, Sales, Investor Support and Relationship Management form the four pillars of AIF distributorship. State whether True or False.**

    a. **True**
    b. False

3. **Which of following disclosures should be made in the section of 'Proposed Investment Strategy' of an Ideal Pitch Book:**

    a. **Investment Opportunity and Expected risk-return profile of the fund/scheme, on implementation of the Investment Strategy**
    b. Key service providers and governance mechanisms
    c. Details of the Distributors appointed by the Fund
    d. Fund Structure and relevant jurisdiction, if fund is an offshore fund

4. **Which type of Insurance covers financial losses on account of 'death', 'incapacity', 'kidnap' or 'disability' of a key executive?**

    a. Professional Indemnity Insurance
    b. D&O Insurance
    c. E&O Insurance
    d. **Key Man Insurance**

5. **Distributors shall enter into Soft Dollar Arrangements with investment managers of a Category III AIF, without disclosing to clients. State whether True or False.**

    a. True
    b. **False**

About NISM

National Institute of Securities Markets (NISM) is an educational institution established by the Securities and Exchange Board of India (SEBI), the securities market regulator, in 2006. The Institute was established in pursuant to the Union Finance Minister's proposal, in his 2005-06 Budget Speech, to set up an institution 'for teaching and training intermediaries in the securities markets and promoting research'.

NISM is committed to its vision 'to lead, catalyze and deliver educational initiatives to enhance the quality of securities markets'. The Institute conducts a wide range of capacity building programmes in securities markets - from basic financial literacy to full-time post-graduation programmes. The Institute's six Schools of Excellence, viz., School for Certification of Intermediaries, School for Securities Education, School for Investor Education and Financial Literacy, School for Regulatory Studies and Supervision, School for Corporate Governance and School for Securities Information and Research upholds NISM's vision and works in synergy towards professionalizing the markets.

NISM is mandated by SEBI (Certification of Associated Persons in the Securities Markets) Regulations, 2007 to conduct certification examinations and continuing professional education programs for associated persons engaged by an intermediary. NISM also conducts certification examinations for other regulators like IBBI and PFRDA. NISM's certifications establish a single market-wide knowledge benchmark for different functions in the Indian securities market and enable the associated persons to advance their knowledge and skills.

About the Workbook

This workbook has been developed to assist candidates in preparing for the National Institute of Securities Markets (NISM) Alternative Investment Funds (Category III) Distributors Certification Examination. NISM-Series-XIX-B: AIF (Category III) Distributors Certification Examination seeks to create a common minimum knowledge benchmark for persons working as Distributors and Placement Agents in AIF domain in India and aims to enhance the quality of sales and distribution and enable better quality investor services. The certification examination focuses on Category III AIFs.

The book covers basic understanding of the alternative asset classes, alternative investment funds in India, role and functions of various stakeholders in AIF ecosystem (such as Sponsor, Investment Management Company, Distributors, Investors). The book also discusses, in depth, about the Category III AIFs, its suitability and related regulations. The book also provides an understanding of the valuation techniques, investment strategies, and performance evaluation along with benchmarking policies adopted by AIFs. It further discusses about the taxation aspects and the good practices to be followed by the distributors servicing the Category III AIFs market in India.

NATIONAL INSTITUTE OF SECURITIES MARKETS

NISM Registered Office
5th floor, NCL Cooperative Society,
Plot No. C-6, E-Block, Bandra Kurla Complex,
Bandra East, Mumbai, 400051
Tel: +91-22-41738811

NISM Campus
Plot No. IS 1 & 2, Patalganga Industrial Area,
Mohopada, District Raigad,
Maharashtra–410222
Tel: +91-2192-668300/01

NISM Bhavan
Plot No. 82, Sector–17,
Vashi, Navi Mumbai, Maharashtra–400703
Tel: +91-22-66735100/5101
Fax: 022-66735110

www.nism.ac.in