NISM CERTIFICATION EXAMINATION WORK BOOK

XIX-A

Alternative Investment Funds (Category - I and II) Distributors

NISM

National Institute of Securities Markets

A Capacity Building Initiative of SEBI

Workbook for

NISM-Series-XIX-A: Alternative Investment Funds (Category I and II) Distributors

Certification Examination

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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 I and II) Distributors.

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Sashi Krishnan
Director, NISM

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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.

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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 I and II) 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 I and Category II AIFs.

Examination Objectives

On successful completion of the examination the candidate should:

- Know the basics of alternative asset class and the Alternative Investment Funds (Category I and II) markets in India.
- Understand the following in detail:
    - General concepts prevalent in the AIF industry.
    - Structure, risk-return relationship, investment process, governance aspects, monitoring and exit strategies of AIFs.
    - Importance of fund due diligence, legal documentations and negotiation skills along with the assessment of risk & return by the investors.
    - Valuation process and methodologies followed by the AIFs for its investee companies.
    - Various taxation aspects for the fund and its investors.
    - Role and conduct of distributors in servicing the investors
    - Understand the back end, documentation and reporting.
- Know the regulatory environment in which the AIFs (Category I and II) 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 percent. 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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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
- Distinction between alpha and beta
- 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. 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).[1] Traditional investments cater to general investors who seek investment options which provide better returns than mere savings schemes.

Alternative investments evolved over time to cater to the requirements of sophisticated investors such as institutional investors managing pools of funds and High net-worth individual investors (HNIs) who have higher risk-taking capability and need more sophisticated avenues than traditional investment options. Unlike traditional investments, alternative investments are about investing in opportunities that can potentially generate higher returns but entail higher risk-taking as well. However, given their nature, alternative investments are only meant for risk-taking sophisticated investors who are either fund managers with institutional experience or portfolio managers for HNIs. Alternative investments are meant to complement traditional investments for such investors by improving their risk-adjusted returns over the long term (see Table 1.1).

[1]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 development Project SPVs	Units issued by Real Estate Investments Trusts (REITs) and Infrastructure Investment Trusts (InvITs) offering stable cash flow and rating
Exchange traded simple derivative instruments such as futures & options used to manage portfolio risk on equities	Direct investment in commodities	Mutual funds with alternative or contrarian strategies that entail higher risk taking
Exchange traded funds (ETFs)	Hedge Funds, Complex structured products and derivatives such as Collateralised Debt Obligations (CDOs), Over-the-Counter derivatives Distressed Asset Funds that finance or acquire	

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

As may be observed from Table 1.1, traditional investments are primarily on-market opportunities that whose common feature is liquidity, i.e. nearness to cash because they can be exited through the market or by anytime redemption offered by an open ended mutual fund. [2] 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 market or are redeemable through the mutual fund route with some restrictions.

1.1.1 Definition of 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'* 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*

[2]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.

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. Under AIF Regulations, companies in which venture capital is invested are known as Venture Capital Undertakings.

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 Chapter 3.

1.2.3 Real Estate and Infrastructure

Alternative investment is also related to the real estate sector where investment can be made into property development companies or specific projects. While general investors acquire personal properties either for occupation or as long term investment, alternative investors look for more sophisticated and risky investment avenues. These include investment in real estate funds that finance big ticket projects. Such investments entail considerable market risk associated with the sector or illiquidity risk due to long gestation period. Some of these are also structured as real estate Private Equity (PE) funds that provide growth capital to companies engaged in the real estate sector or project specific SPVs. A recent addition to the real estate portfolio is Real Estate Investment Trusts (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 (InvITs) 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.

1.2.4 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).

1.2.5 Others

Other alternative asset classes include mainly derivatives which are speculative contracts with underlying assets such as equities, debt securities, commodities, currencies and other exotic varieties. Derivatives can be bought or sold both on a stock exchange (known as exchange traded derivative contracts) and in off-market bilateral deals (known as over-the-counter or OTC derivatives). Since derivatives are speculative, they involve higher risk-taking than stocks or bonds.

Alternative investment funds that trade in complex derivatives, often using leverage at the fund level are known as 'hedge funds'. 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 trading 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.[3]

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"*. Discussion on hedge funds is outside the scope of this workbook.

Apart from the above, alternative investment asset classes include gems and precious stones, arts and antiques and such other exotic investment opportunities.

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

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

stage was not institutionalised but mostly confined to wealthy individuals. The early merchant banks of UK became the first institutional financiers which later on spread to other parts of Europe and USA.

In parallel, there was also a steady growth and organisation of investment fund pools centred on bank treasuries, endowment funds, pension funds and insurance companies. In the early days of investing, the traditional approach advocated safety over diversity due to which, till the 1920s, institutional investors invested in government securities, mortgages and preference capital. Slowly institutional investing became professionalised to meet the requirement to manage such large pools of investible funds. Around the 1940-50s, US witnessed its first batch of institutional venture funds run by professional venture capitalists that identified venture capital as the early stage risk capital for small businesses. Beginning with the 1950s and 1960s, modern portfolio theory made considerable advances which established the mechanics and advantages of diversification advocating the principle that risk from alternative investments can be diversified. 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 later 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.[4] 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.

1.4 Distinguishing 'Alpha' and 'Beta'

In the investment world, the words 'beta' and 'alpha' are often heard in the lexicon of investment managers. Let us understand their connotation and distinction.

Beta is the representation of what is known as 'systematic risk' or the non-diversifiable risk associated with traditional investments in stocks in the capital market. Each stock has a specific beta that measures its responsiveness or volatility to changes in the overall market volatility, often represented by a benchmark index. So if a stock has a beta of 1.0, it perfectly mirrors the market volatility. If the beta of a stock is less than 1.00, it is less volatile (and therefore less risky) than the market and vice versa.

In alternative investments, there would be some assets that may have a substantial amount of beta in them, i.e. much of the risk of the asset is due to factors that are common to other investments on the stock market such as equity market risk, interest rate risk, and currency risk. There could also be categories of assets or specific assets that may have distant correlation to systematic risk and hence less beta factor in them such as new technology companies or businesses with special attributes.

In contrast, the word 'alpha' is often meant to denote excess return as compared to market returns emerging from assuming systematic risk. Therefore, alpha has two connotations –

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

1) Alpha is the excess return expected from assuming 'unsystematic risk' which is associated with investing in alternative investments that may differ from traditional investments due to illiquidity, lower credit quality or other distinguishing factors. Under this connotation, alpha represents the difference between the observed return of an asset and the observed return of its market benchmark or other comparable performance measure, after adjusting for risk differences between the asset and the benchmark.

2) Under the second connotation, alpha represents an expected superior profit due to the use of skill of the fund manager in the selection and allocation of investments. In other words, let's say that a portfolio is invested in index stocks. It will have a beta or systematic risk that is associated with the index and the returns would be equal to market returns. However, if the investments are picked carefully using investment strategies and the portfolio makes more than the market returns, the excess returns or the 'alpha' is attributable to the superior skill of the fund manager. This type of risk taking is referred sometimes as 'alternative beta' according to some schools of thought.

Alternative investments are all about generating the alpha return for taking unsystematic risks on assets as well as from superior fund management skills. For example, if a private equity or hedge fund has a track record to offer an alpha of 3%–5% over index returns from the capital market, it means that due to the active fund management skills being deployed, the fund is expected to consistently outperform competitively priced assets of similar risk by an average of 3%–5% per year.

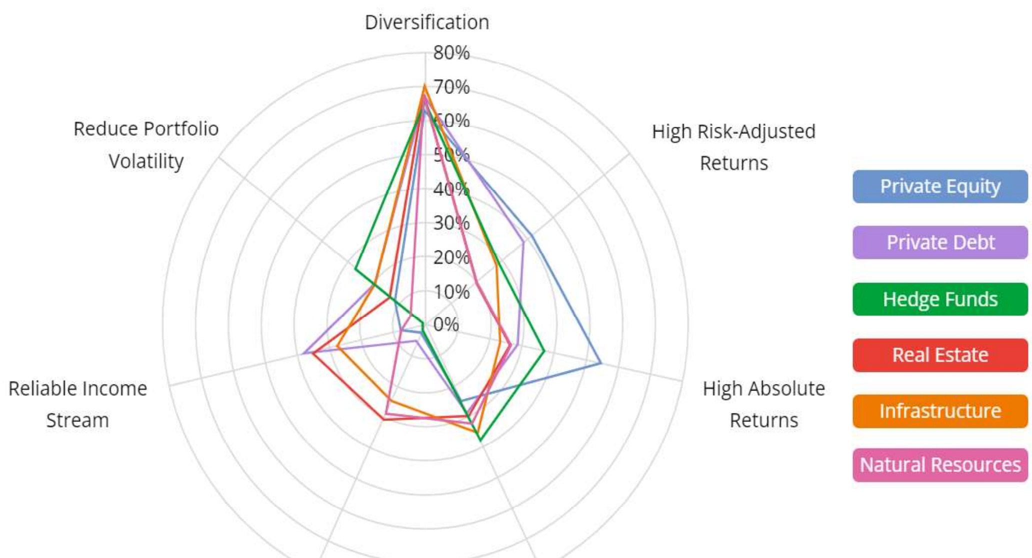
1.5 Role of Alternative Investments in Portfolio Management

Portfolio management needs to be ever-evolving in order to meet improved return expectations of investors. However, this is easier said than done. In the 21st century new challenges have been emerging to generate business returns from established business models due to technological innovations, environmental concerns, regulatory challenges, economic volatility in several economies, geo-political issues and changing needs of markets and customers. 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[5]



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.

[5] Source: www.preqin.com

Table1.2: Comparative Assessment of Alternative Investments

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

The challenge for an asset allocator in the 21st century is to consider alternative investments across markets and asset classes and to decide, as skilfully as possible, which new types of assets to include in a portfolio and which to exclude. Without the inclusion of alternative investments, portfolio management cannot meet the challenge of generating consistent superior returns or the 'alpha' when economic challenges are limiting the returns from traditional investments. At the same time, asset managers have to be mindful of the limitations and risks of alternative investments in terms of untried sectors or technology, business risks, illiquidity risk, market risks, entrepreneurial limitations, contractual risks and economic factors that could limit the alpha generation from such investments. Both empirical analysis and economic reasoning have to be considered equally in making such portfolio diversification choices.

However, there are challenges ahead. Differentiated returns from alternative investments though still strong relative to traditional investments, have slowly begun the journey towards slow down and convergence with public market averages. High valuations in emerging markets, volatile capital markets across the world, anti-globalisation trends, geo-political risks emerging from trade wars and other factors, constant rate reductions by central banks leading to low interest rate risk 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.

Sample Questions: Chapter 1

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 (AIF) 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 (AIF) 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: ALTERNATIVE INVESTMENT FUNDS IN INDIA

LEARNING OBJECTIVES:

After studying this chapter, you should know about:

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

2.1 Evolution and Growth of AIFs in India

The evolution of alternative investments in India can be traced to the modest beginnings in venture capital financing in the 1980s mostly through the initiatives of state level industrial development corporations, financial institutions and a few PSU banks. The reasons for the late emergence of the venture capital industry in India are mostly historical and linked to the state of the capital market and ownership patterns of Indian companies. The Venture Capital Guidelines notified on 25th November, 1988 by the Government of India provided a restricted scope by defining venture capital mainly to include assistance provided to enterprises where the risk element is comparatively high due to a new or untried technology and/or the entrepreneurs being technocrats or first generation entrepreneurs.

The traditional concept of VC being technology risk capital was broad-banded by SEBI in 1996 by notifying a new set of regulations for the VC industry called the SEBI (Venture Capital Fund) Regulations, 1996 which did away with the requirement of looking for 'untried technologies'. The entire spectrum of private capital investment in unlisted companies was thus brought into the ambit of institutional investment. Though the framework for full-fledged venture capital and private equity investments were put in place in 1996, the tax law was not investor friendly. Subsequently, tax breaks were given to VCFs at fund level and the SEBI regulations were also revised following the recommendations of the K.B. Chandrasekhar Committee in 2000. In the dotcom era of 1997-2001, several technology VCFs were set up in India modelled after their Silicon Valley counterparts with VC financing. In the growth phase that followed from 2003 with the emergence of a strong domestic capital market and the impressive growth of corporate India, many Venture Capital Fund and Private Equity Funds emerged mainly with off-shore capital. Domestic institutions such as ICICI, UTI etc. evolved into full-fledged private equity players. However, the representation of domestic private equity was still small in the overall supply of private capital at that time.

From a business perspective, from 2001 onwards, Indian industry was on a consolidation drive in various sectors. Companies sought to grow not only to stand up to competitive market forces in the domestic market but to attain global scale of operations as well. This corporate growth initiative coupled with an investor friendly regime and good economic conditions led to a spurt in private equity activity in India. The first characteristic private equity transaction in India is arguably the USD 292 million investment made by Warburg Pincus in Bharti Televentures Ltd which also resulted in a successful exit strategy for the fund when Bharti was taken public with its IPO in 2002.

In the initial stages, though private equity was largely confined to the information technology sector, by the end of 2007, the sectoral bias was largely removed and private capital had got extended to several other sectors including large scale manufacturing (such as pharmaceuticals, auto-ancillaries, FMCG), real estate and construction, core sectors (like cement, steel, metals) and infrastructure. The interest of private equity also got extended to service sectors such as banking and financial services, logistics, e-commerce, entertainment, healthcare, wellness and education. Private equity investors showed interest even in project financing, an area dominated by large banks and specialised financial institutions. In the real estate and infrastructure sector, private equity has played a role in financing both the developers as well as specific projects. In addition, the Indian market also saw the emergence of buyout transactions spearheaded by funds such as Blackstone, KKR, Actis etc. which acquired controlling interest in both listed as well as closely held companies. The buyout of Flextronics Ltd by KKR in 2006 was a landmark deal.

2.2 Trends Post-2008

The global financial crisis of 2008 had its ripple effects in the Indian markets and accordingly, growth in private equity activity was affected in the following few years. Several funds that had invested in the bullish markets prior to 2008 found it difficult to sustain their investment values. Weak capital market added to their exit woes due to which their follow-on fund raising efforts were also quite unsuccessful. In the years following the global financial crisis, private equity sector in India suffered due to a plethora of sectoral and macroeconomic issues including the scare of regressive taxation laws.

The industry was subdued till 2012 until growth started to pick up significantly from 2014 mostly due to the introduction of the SEBI (AIF) Regulations. But the period between 2011 and 2019 can be termed as the consolidation and transformation phase during which some of the older funds exited and newer funds consolidated their presence. This phase also marked the transformation of a VC and PE industry into an AIF industry. The significant trends during this phase of evolution can be summarised as follows –

– The industry evolved from a predominantly venture capital and private equity industry into a full-fledged alternative investment industry spanning several alternative asset management funds and UHNIs / family offices. For e.g. Real estate sector and infrastructure sector are two examples in point. Further, one can also consider foreign or domestic hedge funds that are registered under AIF Regulations.

- Global events such as Brexit and US-China trade war notwithstanding, private equity inflows and activity reached record levels in Asia Pacific region with India registering highest growth in 2017[6] and 2018[7].
- The significant emergence of domestic capital to support the AIF industry has been evident during this phase. The AIF industry caught the fancy of the ultra-rich billionaires of India. Several new fund houses set up or launched new AIFs to cater to the very wealthy Indian investor community.
- Government reforms were introduced to provide tax incentives to start-ups and recommendations were made by the SEBI Alternative Investment Policy Advisory Committee, headed by Shri. Narayan Murthy, in order to improve the tax regime for Category I AIFs and Category II AIFs to accord them a pass-through status. This has given the much needed boost to the Private Equity and Venture Capital markets and ensured continuous inflow of capital from international and domestic investors such as Sovereign Wealth Fund, Pension Funds, Foundations, Insurance Companies, Banks, Charitable Organizations, Family Offices and High Net Worth Individuals.
- The domestic AIF market grew by identifying new alternative investment opportunities such as pre-IPO financings, special situations such as stressed asset auctions under the Insolvency and Bankruptcy Code 2016, debt resolution refinancing with banks, M&A financings and co-investments, real estate debt financings, mezzanine funding, infrastructure debt and equity funds and so on.
- The emergence of AIF schemes with focus on listed market space is a new phenomenon that emerged in this time period. These funds are akin to hedge funds that take long-short positions on the equity, debt and derivative segments of the stock market. Some of them also focus on special situations such as merger arbitrage, buybacks, de-listings, open offers under the Takeover Code, rights offers and hedging. Several real estate debt funds as well as venture debt funds also emerged with focus on specific niches in the AIF investment world.
- The emergence of e-commerce and digital technology start-ups with cutting edge solutions to myriad service delivery and frontier areas such as fintech, digital payments, artificial intelligence, Internet of Things, Machine Learning, Data Analytics, Cloud Computing etc. has provided a new world of opportunities for AIFs and has also been instrumental in bringing in enormous capital from off-shore AIFs and sovereign wealth funds as well.

[6] PWC Report – Reflections – Indian Private Equity in 2017 Page 2
[7] India Private Equity Report 2019 – Bain & Company

2.3 Types of AIFs

Alternative Investment Funds can be of different types based on their investment strategy and types of assets under management. Under the SEBI (AIF) Regulations 2012, we can list the following types of funds as AIFs –

2.3.1 Venture Capital Fund (VCF)

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".

Further to it, SEBI (AIF) Regulations also defines the following:

(a) 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 (DPIIT), 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.[8]

(b) Venture capital undertaking means a domestic company which is not listed on a recognised stock exchange at the time of making investment.[9]

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.

2.3.2 Angel Fund

Angel Fund means "a sub-category of Venture Capital Fund under Category I AIF that raises funds from angel investors and invests in accordance with the SEBI (AIF) Regulations". Angel Investor means any person who proposes to invest in an angel fund and satisfies one of the following conditions, namely, - (a) an individual investor who has net tangible assets of at least INR 2 crore excluding value of his principal residence, and who has early stage investment experience, or has experience as a serial entrepreneur or is a senior

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

management professional with at least ten years of experience[10], (b) a body corporate with a net worth of at least INR 10 crore or (c) a registered AIF under SEBI (AIF) Regulations, 2012 or a VCF registered under the erstwhile SEBI (Venture Capital Funds) Regulations 1996.

2.3.3 Private Equity Fund

PE Fund means "an AIF which invests primarily in equity or equity linked instruments or partnership interests of investee companies according to the stated objective of the fund"[11]. It may be understood that private equity fund is primarily an equity-based investor but unlike venture capital funds which are focussed on early stage investments, private equity funds are mostly involved in later stage financing in business entities that have established a business model and need to be scaled up for further growth.

2.3.4 Special Situation Fund

Special Situation Fund means a Category I AIF that invests in special situation assets in accordance with its investment objectives and may act as a resolution applicant under the Insolvency and Bankruptcy Code, 2016. Special situation assets include:

a. Stressed loans acquired by Asset Reconstruction Companies (ARCs) or entities permitted by RBI, as part of a Resolution Plan approved through RBI (Prudential Framework for Resolution of Stressed Assets) Directions or a resolution plan as per Insolvency and Bankruptcy Code, 2016.
b. Security Receipts issued by an Asset Reconstruction Company registered with the Reserve Bank of India.
c. Securities of investee companies whose stressed loans are available for acquisition in terms of RBI's Master Direction or as part of a resolution plan approved under the Insolvency and Bankruptcy Code, 2016.
d. Securities of investee companies against whose borrowings, security receipts have been issued by an ARC or whose borrowings are subject to corporate insolvency resolution process under Insolvency and Bankruptcy Code, 2016.
e. Securities of investee companies who have disclosed defaults relating to interest and principal payments on loans from banks, financial institutions, non-banking financial companies and debt securities, in terms of SEBI (Issue of Capital and Disclosure Requirements) Regulations, 2018 and such payment default is continuing for at least ninety calendar days after the occurrence of such default.

[10] Early stage investment experience means prior experience in investing in start-up or emerging or early-stage ventures and a serial entrepreneur means a person who has promoted or co-promoted more than one start-up venture.
[11] Equity linked instruments include instruments convertible into equity shares or share warrants, preference shares, debentures compulsorily or optionally convertible into equity.

2.3.5 Debt Fund

Debt Fund means “an AIF which invests primarily in debt securities of listed or unlisted investee companies or in securitised debt instruments according to the stated objectives of the Fund”[12]. 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 advanced stage of venture capital through mezzanine financing (debt financing with some equity upside like warrants attached to them.). Some private debt funds also finance sub-ordinate debt which can go in funding companies that are already having high senior debt (loans that are secured on the assets and have first claim on cash flow) on their balance sheet, such debt financing is called ‘leveraged loan’. 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 IBC proceedings. Distressed financing is mostly about providing capital for companies to turn 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’. Private debt funds are often classified as a form of private equity funds rather than being treated as another alternative asset class.

2.3.6 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. It is mostly the sovereign wealth funds, multi-lateral funds and sector focused AIFs that operate in this space due to its high illiquidity, long gestation risk in project implementation, long amortisation of the debt and lower equity returns from such Special Purpose Vehicles (SPVs).

2.3.7 SME Fund

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

[12] Vide SEBI (Alternative Investment Funds) (Fourth Amendment) Regulations, 2018 w.e.f. August 13, 2021.

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.

2.3.8 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".

2.3.9 Social Impact Fund

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".[13]

Social venture is a trust or society or company or venture capital undertaking or limited liability partnership formed with the purpose of promoting social welfare or solving social problems or providing social benefits.

2.3.10 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 as may be decided by SEBI. Such debt-oriented mutual fund schemes must ensure that:

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

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

[13] Vide SEBI (AIF) (Third Amendment) Regulations, 2022 w.e.f. July 25, 2022.
[14] Vide SEBI (AIF) (Second Amendment) Regulations, 2023 w.e.f. June 15, 2023

2.3.11 Categories of AIFs

All the types of funds that have been described above are divided into the following categories under the SEBI (AIF) Regulations for the purposes of registration and other operational requirements. These categories are mentioned below.

Category I AIF – is an AIF that invests in start-up or early-stage ventures or social ventures or SMEs or 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, special situation funds, infrastructure 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 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 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.

Specified AIF is a fourth category of AIF inserted by SEBI.[15] This category includes Corporate Debt Market Development Fund as discussed above. Additional categories may be added under Regulation 19 by SEBI from time to time.

2.4 Comparison of AIF Categories

It may be observed from the above definitions that under the SEBI (AIF) Regulations, funds that are economically important or socially impactful and may even enjoy special privileges are bracketed under Category I. Therefore, angel funds, venture capital funds, SME funds, special situation funds, infrastructure funds and social impact funds that are considered important qualify under Category I. Other categories of funds that invest in unlisted space such as debt funds, private equity funds, pre-IPO funds fall under Category II AIFs. Those funds that deploy complex trading strategies in on-market investing (secondary listed

[15] Vide SEBI (AIF) (Second Amendment) Regulations, 2023 w.e.f. June 15, 2023.

market), or in derivatives and may also use leverage at fund level such as hedge funds qualify as Category III AIFs.

Being early-stage investors, VCFs are allowed to invest primarily in unlisted securities (equity or debt or preference capital or other convertible structures) of such start-ups, emerging or early-stage companies. Therefore, the definition uses the word 'securities' to provide latitude to structure the investments appropriately. However, according to the definition, Private Equity Funds are required to invest primarily in equity or equity linked instruments or partnership interests of investee companies. This is because being later stage investors, PE 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-up or early-stage ventures or social ventures or SMEs or stressed assets or infrastructure or other sectors as may be specified.	All AIFs that don't classify under Category I or Category III.	Employs diverse or complex trading strategies and may employ leverage including through investment in listed or unlisted derivatives.
Scope	The sectors should be economically or socially desirable. Primarily, the focus is on early-stage unlisted ventures. Shall include venture capital funds, SME Funds, social impact funds, special situation funds, infrastructure funds and such other AIFs.	They are 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,	Comparatively lesser risk-taking than Category I and III.	Complex risk-taking strategies including

Parameters	Category I AIF	Category II AIF	Category III AIF
	these funds assume higher risks seeking higher return. But risk mitigation strategy is to invest in smaller tranches.	Primarily, seek returns from value creation and unlocking by investing in later stage companies.	trading with borrowed funds at fund level.

The scope of this book is on the discussion pertaining to Category I and Category II funds only. Hence the discussions that follow will be restricted to these two categories only.

2.5 Suitability and Enablers for AIF Products in India

India has seen tremendous economic growth in the post-liberalisation economic era, more particularly in the specific growth phases that followed. The economic prosperity of the entrepreneurial class and corporate executives created several high-net worth investors and family offices. Several NRIs also favour investing in Indian market and alternative investment products are an ideal asset class for being positioned for such investors. After SEBI allowed non-resident non-institutional investors to tap the Indian market as FPIs, it provided additional class of investors to invest in AIFs with India investment focus. India's economic prosperity has been underpinned by the increasing tribe of billion-dollar ultra-high net worth investors (UHNI). The new generation of digital economy entrepreneurship coupled with high valuations of start-up companies is producing wealthy and super-rich class in India much faster than the era of globalisation did in the 1990s and the first decade of the 21st century.

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

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

The introduction of the Insolvency and Bankruptcy Code 2016 created a new space for special situation funds to step in looking for suitable opportunities in distressed asset sector pertaining to old economy companies. In addition, with improved governance, regulations and management practices, the SME sector which is a significant contributor to the growth story has immense potential to cater to the alternative asset class of investors. In view of these developments, the AIF sector is most suitably positioned for investors and investee companies in India in the coming years.
From an external perspective, the lack of growth in developed economies coupled with quantitative easing by the central banks over the past decade has created a situation of excess capital generation in these countries. This excess capital found its way into emerging high growth markets wherein India stands next only to China as a preferred investment destination. India’s large economic potential and favourable investment climate make it a necessary part of the bucket list of global alternative investment funds.

2.6 Current AIF Market Status

AIF market in India has grown manifold post introduction of SEBI (AIF) Regulations in 2012. As on August 30, 2024, 1383 AIFs were registered with SEBI. Starting with just 21 funds in 2012, the industry has seen a high growth in terms of number of registered AIFs. Capital commitments raised by all registered AIFs (across categories) have surpassed INR 11.78 lakh crores as on June 30, 2024.[16]

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

Sample Questions: Chapter 2

1. An AIF that seeks to invest in listed securities on the stock exchange and foreign currency derivatives belongs to which category?

a. Category I

b. Category II

c. Category III

2. A fund that provides both equity and unsecured debt financing to early-stage companies would classify as which one of the following?

a. Venture capital fund

b. Unsecured bond fund

c. NBFC fund

d. Investment Fund

3. An angel fund is a sub-category of a ________ fund.

a. private equity

b. mutual

c. collective investment

d. venture capital

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

a. True

b. False

5. A private equity fund primarily provides unsecured working capital financing to a start-up company. State whether True or False.

a. True

b. False

LEARNING OBJECTIVES:

After studying this chapter, you should know about:

- Private Capital ecosystem consisting of Investors, Sponsors, Trustees, Investment Manages, Custodians, Distributors
- Concepts of due diligence, first close and final close
- Various concepts related to capital such as capital commitment, sponsor commitment, capital invested and drawdown
- Additional returns, fees, expenses, distribution and waterfall
- Environment, Social and Government (ESG) aspects

3.1 The Private Capital Ecosystem

The AIF industry is nurtured by the private capital ecosystem that would consist of primarily the investors looking out for alternative investment opportunities, the alternative investment managers who have the expertise to identify, invest, manage and harvest the returns for investors, the sponsors who initiate and float the AIFs (more often the fund managers themselves) and the various service providers who facilitate and make up the ecosystem. As the AIF industry witnessed significant growth after 2012, many of these constituents of the private capital ecosystem are taking shape rapidly. More importantly, the emergence of domestic AIF investors (both institutional and non-institutional) provided higher impetus to the floatation of several AIFs during this period.

3.1.1 Investors / Contributors

In the international markets, the leading investors in AIF markets are pension funds from both private and public sector. Ultimately, many of the investors in such pension funds are members of the wider public who contribute to pension schemes and collective saving funds and who purchase pension products. Canadian pension funds, the Norwegian pension fund are examples. The next largest investors are insurance companies, trusts and foundations, Endowments and Family offices that contribute to the AIFs. Insurance companies are ideally positioned with large long-term corpuses to become AIF investors.

In the private equity and hedge fund segments, large family offices, sovereign wealth funds (SWFs), investment banks, corporate investors, fund of funds and private wealth management accounts of portfolio managers are the main investors. Corporate investors are large public companies and corporations that incubate smaller companies that are synergistic to their core business. In recent times, due to large trade surpluses generated by oil trade and global commerce, SWFs were started by several countries such as members of the OPEC, China, Japan, Singapore and Malaysia. These SWFs deploy their large dollar corpuses for better returns in emerging markets through the AIF route. In the overseas markets, AIF investors are known as limited partners or LPs as the AIFs are mostly floated as partnerships.

In the Indian market, institutional activity in private capital generation for the AIF industry has been subject to both regulatory and market requirements. The provident funds and pension funds have regulatory caps on their asset exposures in alternative investments in the unlisted space in particular. Since these funds have the largest long duration corpuses, their limited role makes the AIF industry in India different from its counterparts in the West.

Under the AIF Regulations, Indian, foreign and non-resident Indian (NRI) investors can be contributories to the corpus of an AIF.[17][18] However, the minimum investment requirement of each investor is INR 1 crore. The minimum corpus in each scheme shall be INR 20 crore and the maximum number of investors in a single scheme shall not exceed 1000. Moreover, keeping in view the character of an AIF, they are allowed to raise their corpus from investors only through private placement. SEBI has introduced the concept of Accredited Investors in order to provide flexibility to high net worth investors and institutional investors when investing in large value funds under Category I AIFs and Category II AIFs.

Investors under the AIF regulations are called 'unit holders or contributors' or 'partners' or 'shareholders' depending upon the structure adopted for the AIF (trust, LLP or a company).[19] Unit refers to the beneficial interest of the investors in the AIF or a scheme of the AIF and may be fully or partly paid up. Partly paid up units shall represent the portion of committed capital invested by the investor in the AIF or scheme of the AIF.[20]

In the case of AIF trust, the corpus is represented by unit capital. In the case of a company, it would be represented by share capital; and in the case of a partnership, it would be represented as partnership interest. The investment corpus of the AIF trust is known as the 'unit capital'. Unit capital is defined as the beneficial interest of an investor in the AIF or the respective scheme. Unit holder gets proportionate beneficial interest in the corpus based on the number of units held. The economic benefit of the unit will be denoted by the growth in

[17]Foreign investors are governed by the provisions of FEMA which are discussed in Section 4.2. All resident Indian investors (both institutional and non-institutional) can invest in AIFs from their domestic sources. However, domestic institutional investors (DIIs) such as banks, insurance companies and pension funds are further governed by their respective regulations on their eligibility and quantum of investment.
[18]Corpus means the total amount of funds committed by investors to the Alternative Investment Fund by way of a written contract or any such document as on a particular date.
[19] Constitution of an AIF is discussed in Chapter 5.
[20] SEBI (Alternative Investment Funds) (Fourth Amendment) Regulations, 2018 w.e.f. August 13, 2021.

the unit value represented by its net asset value (NAV) that is disclosed by the AIF periodically.

3.1.2 Sponsors

Sponsor means any person or persons who set up the AIF and includes promoter in case of a company and designated partner in case of a limited liability partnership. The application to SEBI for registration of an AIF is made by the sponsor/s. Thereafter, the sponsor invests in the capital of the company or the partnership.

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. These criteria are furnished below.

Criteria for determining a 'fit and proper person' - For the purpose of determining as to whether an applicant or the intermediary is a 'fit and proper person', SEBI may take account of any consideration as it deems fit, including but not limited to the following criteria:[21]

a) Integrity, honesty, ethical behaviour, reputation, fairness and character of the person;
b) The person not having any of the following disqualifications:
    - criminal complaint or charge sheet filed against such person and is pending
    - an order of restraint, prohibition or debarment has been passed against such person or recovery proceedings have been initiated against such person and are pending
    - such person has been declared insolvent or has been categorized as a wilful defaulter
    - such person has been found to be of unsound mind by a court of competent jurisdiction and the finding is in force

Any change in the sponsor or designated partner is required to be informed to SEBI and where there is a change in control of the AIF, prior approval from SEBI is required to be taken by the AIF. Sponsors can be any person or persons including institutions or companies.

The sponsors or designated partners as the case may be, have 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.

[21] Vide SEBI (Intermediaries) (Third Amendment) Regulations, 2021 w.e.f. November 17, 2021.

3.1.3 Trustees

Trustees are required to be appointed in cases wherein the AIF is constituted as a trust. Though the SEBI (AIF) Regulations do not specifically provide for the qualification requirements or certification or legal form for trustees, they do have laid down the Code of Conduct for trustees. SEBI reviews the appointment of the trustee at the time of registration of the AIF and subsequent changes need to be notified and approved by SEBI.

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

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

3.1.4 Investment Managers

Manager means any person or entity who is appointed by the AIF sponsor to manage its investments by whatever name called and may also be same as the sponsor of the Fund. The typical AIF structure in India does appoint an investment management company in which the fund managers will be the principal executives. In a partnership structure that is widely prevalent abroad, the investment managers are known as general partners or GPs. The Manager should also satisfy the requirements of 'fit and proper person' based on the criteria specified in Schedule II of the SEBI (Intermediaries) Regulations, 2008 which are already listed in Section 3.1.2. Any change in the designated partner or Investment Manager has to 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.

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

- **Deal Sourcing** – An AIF manager must identify favourable opportunities, source and complete successful transactions to generate profit and support the raising of further funds. A significant amount of effort and resource is invested in prospecting for transactions and relationship management with external agencies and individuals who may give access to deals. These include investment bankers, chartered accountants, corporate advisers, consulting firms, senior corporate heads and executives, policy makers and others. A large part of the investment manager's time is devoted to networking to create a wider ecosystem for deal generation and execution.

- **Structuring and Investing** – Investment managers need not only be industry specialists but should have very profound deal making skills as well. They have to be keen negotiators and at the same time motivated team leaders to engage with corporate managements and founders of investee companies. They have to create the desired blend of incentives and returns while managing the associated risks.
- **Active Management** – AIF managers have become hands-on managers of their investments. While they do not specifically assume day-to-day management control, they are actively involved in setting and monitoring the implementation of strategy. This is the basis of the argument that AIF investment management is an alternative model of corporate governance to mitigate agency risk in corporate management.
- **Harvest Returns -** The investment managers have to understand the industry and market cycles, their own investment horizon, exit strategy and appropriately harvest returns from their investments. Since AIF is a long term investment strategy associated with illiquidity in many of the fund investments, harvesting returns by managing exit risks is probably the most important skill attribute of an investment manager.
- **Relationship Management with Investors –** Investment managers also need to engage skilfully with their investors such that they are always kept informed of the progress of their fund, new developments shaping the AIF scenario and their fund in particular, launch of follow on funds and so on. This would require timely, regular and appropriate engagement strategy.

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

- A salary from the investment management company or from the fund directly in case the manager is an individual.
- A profit sharing or bonus if any, from the profits of the investment management company.

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

- Management fees[22]
- Additional returns if any, from the AIF, based on performance of the fund and the terms of the investment agreement.

In a **partnership** structure, the investment managers are also the partners along with the investors in the fund. In such a situation, the managers are also contributories to the AIF like

[22]Explained in Section 3.7.1

other investors and their share of the AIF returns would also be available to them as per the terms of the partnership agreement. In the Indian scenario, such contribution is mandatory under the regulations.[23] The investment managers would also be entitled to a salary or management fee as agreed with the investors.

3.1.5 Distributors and Placement Agents

One of the key developments that would shape the growth and proliferation of the AIF industry in India would be the role to be played by distributors and placement agents (also known as the sales and distribution function). Just as in the case of the mutual fund industry which grew phenomenally in India since 1994, the AIF industry's wider reach would depend upon the formation of the distribution and placement network and the effectiveness of their critical role-play. They are important in not only the selling function but in the creation of wider awareness and familiarity among the investor community with regard to AIF products and their potential.

Distributors and placement agents in the AIF ecosystem play the wider role of reaching out to potential investors and distributing the various AIF products that are generated from time to time. Distributors can be individuals or institutions such as distribution companies, broking companies and banks. Coverage on their service aspects is covered in subsequent discussions of the book and in Chapter 13 in particular.

AIF distribution skill does not come easy and requires proper initiation and training. Since most underlying AIF investments in Categories I and II are in unlisted securities, they are illiquid and require long term risk-taking. Investors also need higher risk appetite and risk-taking ability and should therefore typically be high net worth investors (HNIs). Distributors have to understand the needs of investors on a case-to-case basis, have a complete understanding of AIF products they distribute, have reasonable familiarity with underlying risk and return profile of such products and map the requirements of investors with the products they distribute.

3.1.6 Custodians

Asset allocators need to consider custodians not only in the context of the securities that they hold but also with regard to 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 would be in dematerialised form, the custodian is responsible for settlement of transactions and

[23] Explained in a subsequent paragraph.

ensuring that the dematerialised investment accounts of the fund reflect the correct position at any time. The custodian may perform additional activities, such as settlement, tax withholding and proxy voting and also tracks corporate actions such as dividends, bonus and rights in companies where the fund has invested. Custodians may also compute NAV as extended service to a particular fund on case-to-case basis.

All custodians need to register with SEBI under the SEBI (Custodian) Regulations 1996. As per SEBI (AIF) Regulations,[24]

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

The custodian is appointed by the sponsor or manager of the AIF. A custodial agreement is entered into between them. SEBI regulations provide that the custodian shall not be a related party to the sponsors or designated partners unless specific conditions are fulfilled.

3.2 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 the due diligence and to avoid harm to third persons or their property. Due diligence is of particular significance in matters relating to investments, securities markets and corporate businesses. Alternative investments in general, and private alternative investments in particular, require even greater care in meeting the challenges of performing due diligence.

In the AIF domain, due diligence is necessary to be conducted at two levels – (a) at the fund level when investors or unit holders need to subscribe to the corpus of the fund in response to a subscription offer and (b) when the fund makes an investment into an investee company. The fund level due diligence is significant from a distributor perspective to understand the risks in the proposed investment that is being marketed to a prospective unit holder. The investee level due diligence is conducted by the Investment Managers usually through appointed specialised agencies for this purpose. Both these due diligence processes are discussed further in later Chapters.

[24] Vide SEBI (AIF) (Amendment) Regulations, 2024 w.e.f. January 5, 2024.

3.3 Sponsor Commitment

Sponsor commitment is the financial investment required from the sponsor or the investment manager (designated partners in case of a LLP) of an AIF. This commitment from the sponsor / manager is necessary to demonstrate the alignment of interests between them and the AIF so that the unit holders are assured of their best interests being taken care of. Under the AIF Regulations, in Category I and II AIFs, the Manager or Sponsor shall have a continuing interest in the AIF of not less than two and half percent of the corpus of the fund or INR 5 crore whichever is lower. The commitment shall be in the form of investment in the AIF and such interest shall not be through the waiver of management fees. In other words, the commitment shall be demonstrated in cash investment putting capital at risk on par with that of the unit holders. The Manager or Sponsor shall disclose their investment in the AIF to the investors. The continuing interest cannot be withdrawn from the fund and will remain locked until distributions to investors are completed in full. Therefore, the sponsors are the first investors to commit to the fund corpus and would also be the last to be paid out upon winding up. Sponsors may also need to invest more in subsequent tranches to maintain their minimum regulatory commitment if the fund size goes up.

For example, if a fund is floated with a target corpus of INR 50 crore, the sponsor commitment works out to 2.5% thereof (INR 1.25 crore). Let's say the fund has a green shoe option of INR 50 crore. Assuming the corpus including the green shoe is committed fully, the fund has a corpus size of INR 100 crore. The sponsor commitment will now have to be INR 2.5 crore (2.5% of the corpus or INR 5 crore, whichever is lower). Therefore, sponsors have to bring in additional commitment of INR 1.25 crore to fulfil the regulation requirement.

3.4 Capital Commitment

Capital commitment refers to the total funds agreed by investors for subscription to the AIF. Individual capital commitments of each investor are based on their capital allocations to the fund. These may be different for each investor based on the constitution of the investor (institutional or non-institutional) and the type of the AIF. Under the AIF Regulations, the AIF shall not accept from an investor, a capital commitment of value less than INR 1 crore.[25] However, if the investors are the employees or directors of the AIF or the employees or directors of the Manager, the minimum investment value by such employees or directors is INR 25 lakhs. Each scheme of the AIF shall have a corpus (aggregate capital commitments) of atleast INR 20 crore. Partly paid up units shall represent the portion of committed capital invested by the investor in AIF or scheme of the AIF.[26] Capital commitment to an AIF scheme

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

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

provides certainty of funds to the investment manager so that the investments can be planned accordingly and commitments can be entered into with investee companies. However, from the perspective of investors in the AIF, capital commitment means that they have ascertain cash commitment, both in terms of timing of the contribution payments and the total amount that will be drawn down. Usually, a commitment period is specified in the investment agreement during which the capital committed is subject to drawdown by the investment manager.

Thus capital commitment is only the legally binding commitment for a certain amount against future opportunities a fund manager selects for the fund or a particular scheme under the fund. Investors do not deposit the cash with the fund manager. In India, capital commitments have been a combination of both the 'blind pool' structure and other innovative arrangements on a deal-to-deal basis such as co-investments which are described in a Section 3.12. Blind pool structure would mean that capital is committed by the investor to the overall fund and specific investments are made by the manager.

3.5 Capital Invested

It is pertinent to note that AIF funds do not generally drawdown funds until they are needed for financing the investment deals. Invested Capital is the actual amount drawn down by the investment manager from the investors towards their capital commitment to the fund / scheme. For example, if a particular scheme in an AIF has closed with a capital commitment of INR 1000 crore, it does not mean that investors have actually parted with a cash amount of INR 1000 crore. As and when investments are ready for being financed, the fund manager will issue draw down notices to the investors to deposit cash with the fund. At a given time, if the total drawn down amount is, say, INR 650 crore as of date, it would be called the 'invested capital' of INR 650 crore against a 'committed capital' of INR 1000 crore. The undrawn amount of INR 350 crore (1000-650) is known as 'dry powder'.

3.6 Drawdown

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

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

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

- Purposes for which a drawdown can be made
- Schedule of drawdown e.g. initial drawdown, fixed periodic drawdown or drawdown on an *"as-needed"* basis during the commitment period.
- Notice period (number of days for the drawdown of capital) upon serving drawdown notice
- Class wise drawdown and the associated timelines, for e.g. if the unit capital has different classes with different rights attached to them, the drawdowns can be specific to each class of units.
- Mode of issuance of drawdown notice
- Return of drawdown, subject to recall of the drawdown amounts (optional)
- Drawdown post commitment period and the manner in which it will be utilised

The 'initial drawdown', i.e. the first draw down made by the investment manager after the 'first closing' of the fund usually provides for- (i) Management Fees retrospective to first close; (ii) organisational and other expenses attributable to the fund; and (iii) the capital contribution to finance investments made if any, prior to such drawdown.

3.7 Fees & Expenses

3.7.1 Management Fees

The reference to fees and expenses applies primarily to the management fees and expenses chargeable to the fund as per the investment agreement between the fund and the investment manager. There are currently no SEBI regulations in this matter. So far as AIF management fees are concerned under the AIF Regulations. Therefore, reference has to be drawn from industry practices in India and overseas. Management fee is paid by the fund to the investment manager which usually ranges up to 2.5 percent of the capital committed during the commitment period. Thereafter, it reduces to a percentage of only 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). In some cases, investors have requested that the management fee after the commitment period be charged on the original amount of invested capital and not on the amounts utilised towards expenses or management fees.

Management fees can be structured as an advance of any returns payable to the investment manager but are nevertheless payable to the manager even if the fund generates no profits and no returns. This aspect has been a contentious issue with Indian investors. Investors have usually insisted on the fee being a function of the role and responsibilities of the manager. Therefore, early stage and venture capital AIFs could charge a higher percentage as compared to industry standards. The frequency of payment of management fee may be quarterly, semi-annual as is the industry practice or sometimes on annual basis. Goods and Services Tax (GST) is payable on the management fee and is usually charged extra. Disclosures on fee structure are made in the initial offer literature also called private placement memorandum (PPM) to the prospective investors and agreed to subsequently under the terms of the investment agreement. It should be noted that fees may vary depending on the amount the investor commits and timelines of commitment; these are usually captured as fees in different classes of units issued by the fund.

3.7.2 Organisational Expenses

Other fees chargeable to the fund could normally include ‘organisational expenses’ such as incorporation costs, statutory compliance costs of the fund, placement commissions or distribution fees to placement agents and distributors, winding up expenses of the scheme/ fund structure as and when required and other such fund administration costs. These are usually one time and can be charged one time or over a period of time.

3.7.3 Operating Expenses

Expenses of an AIF administration would include apart from organisational expenses, (a) operating expenses and (b) residual or other expenses. The main operating expenses are fees payable to trustee company or trustees, custodian fees, fund accounting fees, legal and audit fees, valuation and reporting costs, bank charges, filing fee, taxes, or any other fees directly attributable to fund transactions etc.

The practices on the payment and chargeability of such fee to the fund as well as the split-up of such fee sharing between the fund and the investment manager vary from case to case. As in the case of management fees, generally, the investment agreement between the investment manager and the fund would specify the details of expenses chargeable to the fund and those to be borne by the investment manager. Usually, investors insist on caps (higher limit) specified to each head of expenses or the overall expenses chargeable to the fund during its life or on annual basis including distribution or placement commissions and other charges / loads if any.

3.7.4 Investment Management Costs

The function of investment management is performed by the manager and accordingly, all such associated costs have to be borne by the manager and cannot be charged to the fund. Internationally, there is a concept of self-managed fund, where the investment manager executives are employees of the fund itself and draw salaries and other expenses from the fund and hence the management fee is lower than the regular funds. Such expenses may include lease or rental charges, office maintenance, travel and outsourced support services, investment due diligence, transaction documentation costs etc. pertaining to deal execution etc. There may also be some residual costs which could include items such as technical consultancy reports, market survey or database access charges etc. that may be required in specific cases of deal execution. Usually, managers do not pay any finder's fee to investment banks or consultants for sourcing deals.

3.8 Preferred Returns and Additional Returns

The preferred return or 'hurdle rate' is a term used in the AIF ecosystem with particular reference to VC and PE funds. It refers to the threshold return that the investors in the AIF (LPs in a partnership) must receive, prior to the investment manager receiving its additional returns if any. In developed markets, the hurdle rates are lower and traditionally are around 8%.[27] Over time with greater competition among fund managers and the wider success of the AIF industry across markets, the expectations on hurdle rates also went up, thereby increasing them. In Indian market, hurdle rates in VC and PE are meant to be higher than the international standards as the historical average returns on the stock market (estimated around 15%[28]) and could therefore be around 10% to 12%. The purpose of having a hurdle rate is to benchmark the expectations of the investors rather than to provide a guaranteed return (which is neither permissible nor possible). Since AIFs are meant to compensate investors for taking higher risk of illiquidity and longer term of holding, hurdle rates have to

[27] According to 'Private Equity Demystified' – icaew.com
[28]BSE 10 year average is about 14.47% according to Bloomberg Quint - https://www.bloombergquint.com/markets/equities/historical-returns.

be in tune with comparable market returns. Notwithstanding the above, investors' expectations are always that managers should aim to outperform the hurdle rates consistently and thereby build their track record.

Additional returns (known as 'carried interest' or simply 'carry' in international markets) are sometimes provided to the investment manager as an incentive to outperform the hurdle rate thereby maximising the fortunes for the investors in the AIF. In developed markets, customarily PE funds have been structured as '2-20' implying that the manager gets 2% management fee and 20% additional returns. Additional returns and the 2-20 structure are not a standard feature in the evolving Indian AIF market. The payment of additional returns and the quantum thereof could depend entirely on the credibility and track record of the sponsor / manager, type of fund, scheme focus and size of the corpus. Investment managers that deliver above preferred return consistently can expect to get additional returns as compared to those that fail to do so. Managers that consistently cannot deliver above the preferred return not only get a much smaller additional return, but also have a tendency to disappear over time as they find it difficult to attract investors to roll out follow-on schemes or float new funds.

The management fees and additional returns (if any), need to be assessed on a periodical basis as per the terms of the investment agreement. By their nature, AIFs are illiquid and their underlying investments cannot be reliably valued until the investments are exited. If AIF management fee is payable as a percentage of the AUM (invested capital of contributors), it may also be linked to the estimated NAV of the fund from time to time. However, additional returns (if agreed to) become payable only upon liquidation of the fund since AIFs are typically structured as closed ended limited life entities. Therefore, additional returns are normally assessed on exits. The fund terms would specify if additional return is calculated on deal-by-deal basis or on aggregate portfolio basis to determine its amount.

The investment agreement would also specify whether additional returns have a 'catch up' provision or not. This clause is meant to make the investment manager's additional return a percentage of the total returns of the fund and not solely on the return in excess of the preferred return. This is explained more in the following paragraph on 'Distribution'.

In some fund arrangements, apart from a hurdle rate, a 'high watermark' may also be prescribed. It is a more common practice in hedge funds. This mark denotes the highest value recorded by the fund corpus in the past. If this level is prescribed, the fund manager gets additional returns only after the corpus value crosses the mark. For example, if a fund has a prescribed hurdle rate of 20% and a high water mark, the additional returns will be computed as follows –

For the first year - upto a fund value of INR 120 crore, additional return would be nil as it is equal to the hurdle rate. Thereafter, if the fund value exceeds INR 120 crore additional return will be calculated on the excess. If the fund value is say, INR 145 crore, additional returns would be calculated on INR 25 crore.

For the following year – Additional returns are calculated only on the fund value in excess of INR 145 crore.
In funds that pay annual performance incentives to fund managers, having a high watermark ensures that they don't get paid multiple times for the fund value already achieved in the past. This is the reason why this arrangement is more common in hedge funds.

3.9 Distributions / Waterfall

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

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

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

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

3.9.1 Clawback

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

In the Indian scenario, it is customary to include a reserve creation in the waterfall to provide for unforeseen tax liability or other charges, especially in funds involving offshore investors. Alternatively, there could be a 'giveback' clause whereby some amounts are adjusted against givebacks by the investors from distributions. Giveback may work better for the manager than creation of reserves as preferred returns need not be provided on the giveback amounts. Table 3.1 provides an illustrative distribution waterfall for better understanding.

Table 3.1 – Illustrative Distribution Waterfall

Distribution proceeds consist of amounts realised from investments made by the AIF utilising the corpus created from contributions received from investors. Realisations are both periodic during the life of the fund as well as at the termination of the fund as and when investments made are exited. The waterfall provided below represents the priority of payments on both such proceeds taken together.

Priority Sequence	Description
1. Expenses, taxes and statutory payments	Expenses chargeable to the fund, Income tax on investment gains, GST and other statutory dues payable from time to time.
2. Reserves	The investment manager may decide to retain some proceeds to create reserves for meeting future liabilities entirely at its discretion. Such terms would be mentioned in the PPM.
3. Management Fees and other costs	The management fees of the investment manager, other costs chargeable to the fund.
4. Net Proceeds	If the fund has different classes of units, there may be priority in payment inter-se among such classes. Such details would be mentioned in the PPM. For e.g. if investors from the First Close have a priority over investors from subsequent closes. In general terms, subject to specific terms of a particular fund distribution, net proceeds are to be applied firstly to repay corpus contributions of investors of a particular class on a pro-rata basis and then towards preferred return as per the terms of the contribution agreement with each class / investor. As explained above, in a European waterfall, the manager does not get any returns until the preferred returns are paid out 100%.
5. Additional Returns / Incentives / Carry with Catch Up	If the manager / carried interest holders are entitled to additional returns/ incentives / carry with a catch up clause, the catch up gets paid at this stage so that it equates them to the agreed share on the total return of the scheme / fund.
6. Residual distribution	This is distributed in the ratio of sharing between investors and managers holding carry. In case there is no catch up

	clause in the investment agreement, step (5) above is skipped and residual proceeds are shared after step (4). The result would be that the carry (%) would be less when computed on the total return of the fund as it is calculated only on proceeds remaining after step (4).

3.10 First close and Final close

When fund managers launch a new fund, these are usually set with a specific target minimum corpus based on the theme of the specific scheme of investment. Many a time, there is also a maximum cap which needs to be specified at the time of SEBI registration. The maximum cap can either be a 'hard cap' that cannot be breached, or a 'soft cap' that is there to guide investors about the fund aspirations but can be extended as per requirements. Once a fund has received commitments over the minimum corpus or has completed a stipulated period of fund raise, it may declare a 'first close'. This represents a commitment by the AIF to investors to proceed with the fund and also acts as a signal to those who may be waiting to see how a fund raising is progressing and that the fund is indeed successful in getting launched. The investment manager would retain the right to accept subsequent contributions from investors and declare subsequent or rolling close dates. The terms of the fund will specify that the 'final close' would happen not later than a specified period under the AIF Regulations after the first close at the call of the investment manager /with necessary approvals.

As the AIF investing ecosystem stiffened over time with increase in the demand side due to several fund launches and on the supply side due to challenges in finding good AIF opportunities, it has become increasingly common for AIF managers to offer investors preferential terms if they commit to invest before the first close. The intention is to entice investors into the fund as early as possible and to build momentum that enables the fund manager to close the fund-raising as soon as possible. A fast and successful fund-raising is considered a sign of a successful AIF fund management. Conversely a long fund-raising is deemed to be indicative of a weaker proposition.

In line with the inducement for attracting investors to the first close of a fund, could also levy additional contribution / entry loads for on-boarding investors into subsequent closings after the first close. These entry loads could be in terms of compensatory contributions which will entail putting in extra contribution to bring subsequent investors on par with earlier investors.

3.11 Private Placement Memorandum (PPM)

The Private Placement Memorandum or PPM is the offer document that is issued by the sponsor / manager to the prospective investors in connection with inviting subscriptions for a fund to be floated / follow on fund / new scheme in an existing fund. The PPM sets out the broad terms and conditions subject to which the fund is proposed to be operated and necessary disclosures in connection therewith. The PPM is of particular relevance to distributors who need to familiarise themselves with its principal terms, disclosures on commercial aspects, distribution waterfall, risks associated with the fund investment and so on. This knowledge is fundamental to marketing the right product to investors and making them understand the potential and risks therein. The PPM and its contents are discussed more in detail in Chapter 9.

3.12 Co-investments

Co-investments are a unique market practice in the AIF industry. As per SEBI Regulations, co-investment means investment made by a Manager or Sponsor or investor of Category I AIFs and Category II AIFs in investee companies where such Category I AIF and Category II AIF make investment.[29] Under this arrangement, an investor gets the right to directly invest in an investee company in parallel to the investment being made by the AIF. For this purpose, the investor negotiates the special right of co-investment with the AIF at the time of subscription to the fund. The rationale for the investor in having such co-investment right is to be in a position to benefit from a larger direct exposure to an attractive investment opportunity that may bring overall improvement in the return on the portfolio. Without the co-investment right, the investor's return depends upon the performance of the scheme alone. Co-investment rights are not a standard feature and these are generally offered to preferred investors by the fund managers. More discussion on this aspect is provided in Section 7.5

3.13 Term Sheet and Summary of Principal Terms (SOPT)

The term sheet is an important milestone in the process of conducting an investment transaction by which the AIF invests in an investee company. This is not a legal agreement and is therefore not binding on both parties. It is the first step in reaching an understanding between the AIF and the investee company which would pave the way for both parties entering into binding investment agreements. The SOPT summarises the main terms and conditions as per which the AIF expresses its willingness to invest in the company. The term sheet would be subject to further discussion between both parties and there could be

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

further negotiations to fine tune it. Term sheets once executed, usually have a validity period during which the transaction will be completed by both parties. Further discussion is furnished in Section 7.1.4.

3.14 Environmental, Social and Governance

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

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

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

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

As far as India is concerned, considering the growing importance of ESG compliance in business domain, regulations are already moving in that direction. In August 2012, SEBI issued Business Responsibility Reporting (BRR) norms for the top 100 listed entities, thereby stipulating non-financial reporting by corporate India. The BRR norm was later extended gradually to the top 500 and top 1000 listed entities by market capitalisation. The BRR captures an organisation's non-financial performance across economic, environmental and social factors. This reporting requirement is in line with the 'National Voluntary Guidelines on Social, Environmental and Economic Responsibilities of Business (NVGs)' notified by the Ministry of Corporate Affairs, Government of India, in 2011. These guidelines contain comprehensive principles to be adopted by companies as part of their business practices and a structured business responsibility reporting format requiring certain specified disclosures, demonstrating the steps taken by companies to implement the said principles. Further with increased focus towards sustainability investing globally, SEBI reviewed the BRR norm and improved the ESG related disclosures with the introduction of Business Responsibility and Sustainability Reporting (BRSR).[30] The BRSR is intended towards having quantitative and standardized disclosures on ESG parameters to enable comparability across companies, sectors and time. Disclosures as per the BRSR are mandated for top 1000 listed entities by market capitalisation effective from FY 2022-2023. SEBI further issued a circular which mandated 9 specified Key Performance Indicators (KPIs) for ESG reporting under the BRSR regime for the value chain of a company's business.[31] Disclosures for value chain shall be made by the listed company as per BRSR Core, as part of its Annual Report. For this purpose, value chain shall encompass the top upstream and downstream partners of a listed entity, cumulatively comprising 75% of its purchases/ sales (by value) respectively. SEBI also introduced comprehensive regulation for ESG Ratings and ESG Rating Providers (ERPs).[32] These provisions provide for types of ESG Ratings/ Scores, business of ERPs, rating process, disclosures and reporting and connected matters.

[30] Vide SEBI Circular No.: SEBI/HO/CFD/CMD-2/P/CIR/2021/562 dated May 10, 2021 on Business responsibility and sustainability reporting by listed entities
[31]SEBI/HO/CFD/CFD-SEC-2/P/CIR/2023/122 dated July 12, 2023.
[32]SEBI/HO/DDHS/POD2/P/CIR/2023/121 dated July 12, 2023.

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

Sample Questions: Chapter 3

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

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

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

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

3. ___________ is a function of the investment manager.

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

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

a. True
b. False

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

a. True
b. False

LEARNING OBJECTIVES:

After studying this chapter, you should know about:

- Various provisions of SEBI (AIF) Regulations, 2012
    - Registration requirements, registration criteria and documentation, conditions for registration
    - Sponsor/ Manager commitment
    - Tenure of fund and scheme
    - Raising of corpus capital and Placement Memorandum
    - Investment conditions for AIFs (general and specific to Category I and II)
- General provisions of Foreign Exchange Management Act, 1999
    - Investment framework, concept of Residence
    - Investments by NRIs and PIOs
    - Foreign investments in AIFs and Overseas investments by AIFs

4.1 SEBI (Alternative Investment Funds) Regulations 2012

This chapter outlines the important provisions of the SEBI (Alternative Investment Funds) Regulations, 2012, apart from the various types of funds and their definitions which have been explained in earlier Chapters.

4.1.1 Registration Requirements

On and from the commencement of these Regulations, all existing and proposed AIFs that are domiciled in India by virtue of being incorporated in India are subject to compulsory registration with SEBI. Existing schemes will be allowed to complete their agreed tenure, however, such funds shall not raise any fresh monies other than commitments already made till registration is granted. The funds registered as venture capital fund under SEBI (Venture Capital Funds) Regulations, 1996 shall continue to be regulated by the said regulations till the existing fund or scheme managed by the fund is wound up. Such funds may seek re-registration under SEBI (AIF) Regulations subject to approval of two-thirds of their investors by value of their investment.

AIFs may seek registration as Category I or II or III as appropriate to their investment strategy. In addition, AIFs can seek registration as Specified AIF, for which SEBI has laid out detailed regulations. The features of Category I and II AIFs are explained earlier. Category I funds are venture capital funds which are generally perceived to have positive spill over effects on economy and for which SEBI or the Government of India or other regulators in India might consider providing incentives or concessions. Category II AIFs are funds which do not satisfy the requirements of Category I and Category III and which do not undertake leverage or borrowing other than to make day-to-day operational requirements. Such Category II AIFs include private equity funds or debt funds. The application seeking registration shall be made in Form A as specified in the SEBI (AIF) Regulations accompanied by a non-refundable application fee.

4.1.2 Registration Criteria and Documentation

SEBI decides on the eligibility and registration of an AIF by examination of the given documents and criteria for eligibility. These are listed below.

1. The Memorandum of Association in case of a company (registered under the Companies Act or any Central / State Act); or the Trust Deed in case of a Trust (registered under the Indian Trusts Act, 1882 and the Registration Act, 1908); or the Partnership deed in case of a limited liability partnership (registered under the Limited Liability Partnership Act, 2008) permits it to carry on the activity of an AIF. SEBI may stipulate additional information requirements and filing of other documents in individual cases.
2. AIFs are prohibited from making an invitation to the public to subscribe to its units. Accordingly, such prohibition should be included in the memorandum and articles of association / or trust deed / or partnership deed of the applicant.
3. The applicant, Sponsor and Manager are fit and proper persons based on the criteria specified in Schedule II of the SEBI (Intermediaries) Regulations, 2008;
4. The key investment team of the Manager of Alternative Investment Fund shall fulfil the following criteria:
   (a) At least one key personnel shall have the relevant certification as specified by SEBI. In case of expiry of the validity of such certification, the personnel shall obtain fresh certification to ensure compliance with certification norms.[33] and
   (b) at least one key personnel with professional qualification in finance, accountancy, business management, commerce, economics, capital market or banking from a university or an institution recognised by the Central or any State Government or a foreign university or a CFA charter from CFA Institute or any other qualification as may be specified by SEBI; provided that both the requirements, as stated in 4(a) and 4(b), are fulfilled by the same key personnel;
5. The Manager or Sponsor has the necessary infrastructure and manpower to effectively discharge its activities;

[33] Vide SEBI (AIF) (Second Amendment) Regulations, 2023 dated June 15, 2023, effective from May 10, 2024.

6. The applicant has clearly described at the time of registration the investment objective, the targeted investors, proposed corpus, investment style or strategy and proposed tenure of the fund or scheme;
7. Whether the applicant or any entity established by the Sponsor or Manager has earlier been refused registration by SEBI.

4.1.3 Conditions for Registration

1. The AIF shall abide by the provisions of the Act and the SEBI (Alternative Investment Funds) Regulations, 2012;
2. The AIF shall not carry on any other activity other than permitted activities;
3. The AIF shall forthwith inform SEBI in writing, if any information or particulars previously submitted to SEBI are found to be false or misleading in any material particular or if there is any material change in the information already submitted.
4. An Alternative Investment Fund which has been granted registration under a particular category cannot change its category subsequent to registration, except with the approval of SEBI.

4.1.4 Sponsor / Manager Commitment

1. The Manager or Sponsor shall have a continuing interest in the AIF (in each scheme where there are multiple schemes in the fund) of not less than 2.5% of the corpus or INR 5 crore whichever is lower, in the form of investment in the AIF and such interest shall not be through the waiver of management fees proposed to be earned by managing the fund.
2. The contribution of each employee or director of the fund or employee or director of the investment manager in the corpus shall not be less than INR 25 lakh if they choose to participate as investors in the fund in individual capacity.
3. The Manager or Sponsor shall disclose their investment interest in the AIF to the investors.

4.1.5 Co-investments

Co-investment means investment made by a Manager or Sponsor or investor of Category I AIFs and Category II AIFs in investee companies where such Category I AIF and Category II AIF make investment.[34] Co-investment by investors of Category I AIF and Category II AIF shall

[34] Vide SEBI Circular No. SEBI/HO/IMD/IMD-I/DOF6/P/CIR/2021/663 dated November 22, 2021 on Clarifications regarding amendment to SEBI (AIF) Regulations, 2012.

be only through a Co-investment Portfolio Manager as specified under the SEBI (Portfolio Managers) Regulations, 2020.

The terms of Co-investment in an investee company by a Manager or Sponsor or co-investor, shall not be more favourable than the terms of investment for the Category I AIF or Category II AIF. Also, the terms of exit from the Co-investment in an investee company, including the timing of exit, shall be identical to the terms applicable to that of exit of the Category I AIF or Category II AIF. These provisions will be applicable for co-investments made after December 08, 2021.[35] Further, the manager shall not provide advisory services to any investor other than the clients of Co-investment Portfolio Manager as specified in SEBI (Portfolio Managers) Regulations, 2020, for investment in securities of investee companies where the fund makes investment.

4.1.6 Tenure of Fund and Schemes

1. As defined by the SEBI (AIF) Regulations, tenure of a scheme refers to the duration of the scheme from the date of first close till last date of the term as specified in the fund documents.
2. Category I and Category II AIFs shall be close ended and the tenure of fund (if there is only one scheme under it) or each scheme therein shall be determined at the time of application to SEBI subject to a minimum tenure of three years. The trust or incorporated entity may have a different term as per its incorporation documents but each scheme of the AIF (in Category I and II) needs to be close ended for a defined term.
3. Extension of the tenure of the close ended AIF may be permitted up to two years, subject to approval of two-thirds of the unit holders by value of their investment in the AIF.
   However, large value funds for accredited investors may be permitted to extend its tenure upto 5 years, subject to the approval of two-thirds of the unit holders by value of their investment in the AIF.[36]
4. In the absence of consent of unit holders or upon expiry of the extended tenure, the AIF shall be wound up as per SEBI (AIF) Regulations.[37]

[35] SEBI (AIF) (Fifth Amendment) Regulations, 2021 w.e.f. December 08, 2021.
[36] Vide SEBI (AIF) (Fourth Amendment) Regulations, 2024 w.e.f. August 7, 2024.
[37] Vide SEBI (AIF) (Second Amendment) Regulations, 2023 w.e.f. June 15, 2023.

4.1.7 Accredited Investor, Accreditation Agencies and the Accredited Investor Framework (AI Framework)[38]

SEBI introduced the framework for Accredited Investors (AIs) in the Indian securities markets. As per the framework, the AIs may avail (a) flexibility in minimum investment amount and (b) concessions from specific regulatory requirements applicable to investment products, subject to specific conditions.

Accredited Investors

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

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

- Eligibility Criteria for accreditation is as follows:
  - annual income should be at least INR 2 crores; or
  - net worth should be at least INR 7.5 crore, out of which not less than INR 3.75 crores should be in the form of financial assets; or
  - annual income should be at least INR 1 crore and minimum net worth to be INR 5 crore, out of which not less than INR 2.5 crore should be in the form of financial assets,

- In case of accreditation of Individual investors, HUFs and sole proprietorships, the value of the primary residence of the Individual, Karta of the HUF, or the Sole Proprietor, as the case may be, shall not be considered for calculation of net worth.

- In case of joint investors in a fund, the following additional conditions shall apply:
  - If joint holders are parent(s) and child(ren), at least one person should independently fulfil the eligibility criteria for accreditation.
  - If joint holders are spouses, their combined income/net worth should fulfil the eligibility criteria for accreditation.

- In case of a partnership firm set up under the Indian Partnership Act, 1932, each partner should independently meet the eligibility criteria for accreditation.

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[38] Vide SEBI (Alternative Investment Funds) (Third Amendment) Regulations, 2021 w.e.f. August 3, 2021; and SEBI Circular No. SEBI/HO/IMD/IMD-I/DF9/P/CIR/2021/620 dated August 26, 2021 on Modalities for implementation of the framework for Accredited Investors and SEBI Circular No.: SEBI/HO/AFD/PoD1/CIR/2023/189 dated December 18, 2023.

- 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.

B. Body Corporates and Trusts:

- In case of a body corporate, net worth is at least INR 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 INR 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 institutions are deemed to be an accredited investor and may not be required to obtain a certificate of accreditation:

- Central Government and the State Governments
- Developmental agencies set up under the aegis of the Central Government or the State Governments
- Funds set up by the Central Government or the State Governments
- Qualified institutional buyers as defined under SEBI (Issue of Capital and Disclosure Requirements) Regulations, 2018
- Category I foreign portfolio investors
- Sovereign wealth funds and multilateral agencies
- Any other entity as may be specified by SEBI from time to time

Accreditation Agency

'Accreditation Agency' means a subsidiary of a recognized stock exchange or a subsidiary of a depository or any other entity as may be specified by SEBI. Investors desirous of being reckoned as Accredited Investors (AIs) need to submit an application to the Accreditation Agency. The applicants should be "fit and proper" to participate in the securities market and not be wilful defaulters or have convictions or restraint orders against them.

The Accreditation Agencies are required to have the requisite infrastructure including systems and manpower to fulfil their responsibilities.

Accreditation Agencies or KYC Registration Agencies (KRAs) can access Know Your Customer (KYC) documents of applicants available with them in capacity of KRA, or access the same from the database of other KRAs, for the purpose of accreditation. The Agency should issue an "Accreditation Certificate" to eligible accredited investors, bearing a unique accreditation number, name of the Accreditation Agency, PAN of the applicant and validity of the accreditation with a start date and an end date. Accreditation shall be granted solely based on the KYC and the financial information of the applicants.

Accreditation Certificate shall include the following disclaimer:

"The assessment of the applicant for accreditation is solely based on the applicant's KYC and financial information and does not in any manner exempt market intermediaries and pooled investment vehicles from carrying out necessary due diligence of the accredited investors at the time of on boarding them as their clients."

The accreditation shall be valid for a period of 2 years, from the date of such accreditation, if the applicant meets all eligibility criteria for the preceding one year. If the applicant consistently meets the eligibility criteria in each of the two preceding financial years, the accreditation shall be valid for a period of 3 years, from the date of such accreditation. If the applicant is a newly incorporated entity, which does not have financial information for the preceding financial year but meets the applicable net-worth criteria as on the date of application, the accreditation certificate issued shall be valid for two years from the date of such accreditation.

The Accreditation Agencies are responsible for:

- Verification of documents submitted by the applicants
- Timely processing of applications for accreditation and issuance of Accreditation Certificate
- Maintaining data of accredited investors
- Verification of accreditation status
- Maintaining confidentiality of investor information
- Any other responsibilities as may be specified by SEBI

Large value fund for Accredited Investors

"Large value fund for accredited investors" means an AIF or scheme of an AIF in which each investor (other than the Manager, Sponsor, employees or directors of the Fund or employees or directors of the Manager) is an accredited investor and invests not less than INR 70 crores.

4.1.8 Raising of Corpus Capital and Placement Memorandum

1. The fund shall not solicit or collect funds for corpus creation except by way of private placement of units (partnership interests in the case of an LLP and equity shares or other securities in the case of a company).
2. Units of close ended AIF may be listed on a stock exchange subject to a minimum tradable lot of INR 1 crore. Listing of such shall be permitted only after final close of the fund or respective scheme.
3. The AIF may raise funds from any investor whether Indian, foreign or non-resident Indians by way of issue of units, subject to the provisions of the FEMA, 1999.
4. Each scheme of the AIF shall have a corpus of at least INR 20 crore.
5. The individual commitment/ subscription / partnership interest of each investor in a fund or respective scheme shall not be less than INR 1 crore.[39] In case investors are employees/directors of the AIF or employees/directors of the Investment Manager of the AIF, the minimum amount of investment from such investors shall be INR 25 lakh.
6. An AIF can accept the following investors as joint investors:
   - an investor and his/her spouse
   - an investor and his/her parent
   - an investor and his/her daughter/son

   and not more than 2 persons shall act as joint investors. In case of any other investors acting as joint investors, for every investor, the minimum investment amount of INR 1 crore40 shall apply.[41]

7. No scheme of the AIF shall have more than 1000 investors. In the case of a company, this limit is regulated by the Companies Act, 2013.
8. The raising of corpus capital shall be through private placement by issue of an information memorandum or placement memorandum. Such Private Placement Memorandum (PPM) shall contain all material information about the AIF and the Manager, background of key investment team of the Manager, targeted investors, minimum size of the corpus with green shoe option, if any, periodic reporting obligations and information disclosures about the performance of the scheme, fees and all other expenses proposed to be charged, tenure of the AIF or scheme, conditions or limits on redemption, investment strategy, risk management tools and parameters employed, key service providers, terms of reference of the committee

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[39] Not applicable to Accredited Investors, as per SEBI (Alternative Investment Funds) (Third Amendment) Regulations, 2021.
[40] Not applicable to Accredited Investors, as per SEBI (Alternative Investment Funds) (Third Amendment) Regulations, 2021
[41] SEBI Circular No.: CIR/IMD/DF/14/2014 dated June 19, 2014 on Guidelines on disclosures, reporting and clarifications under AIF Regulations.

constituted for approving the decisions of the Fund,[42] conflict of interest and procedures to identify and address them, disciplinary history, the terms and conditions on which the Manager offers investment services, its affiliations with other intermediaries, manner of winding up of the AIF or the scheme and such other information as may be necessary for the investor to take an informed decision on whether to invest in the AIF.

9. The PPM shall be filed with SEBI along with the specified fees, through a merchant banker.[43]
10. 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.

    However, the requisites stated in point nos. 9 and 10 above do not apply to large value fund for accredited investors.[44]

4.1.9 General Investment Conditions for all AIFs

1. All AIFs shall state investment strategy, investment purpose and its investment methodology in its PPM to the investors. Any material alteration to the fund strategy shall be made with the consent of at least two-thirds of unit holders by value of their investment in the AIF or the respective scheme.
2. AIFs may invest in securities of companies incorporated outside India subject to FEMA and such conditions or guidelines that may be stipulated or issued by the RBI and SEBI from time to time.
3. Category I and II AIFs shall invest not more than 25% of the investable funds in one Investee Company directly or through investment in the units of other AIFs.[45] However, large value funds for accredited investors of Category I and II AIFs may invest up to 50% of the investable funds in an investee company directly or through investment in the units of other AIFs.[46]

    Investable funds means corpus of the scheme of AIF net of expenditure for administration and management of the fund estimated for the tenure of the fund.[47]
4. Category I and II AIFs which are authorised under the fund documents to invest in units of AIFs shall not offer their units for subscription to other AIFs.[48]

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[42] SEBI (Alternative Investment Funds) (Second Amendment) Regulations, 2021 w.e.f. May 5, 2021.
[43] SEBI (Alternative Investment Funds) (Fourth Amendment) Regulations, 2018 w.e.f. November 11, 2021.
[44] SEBI (Alternative Investment Funds) (Amendment) Regulations, 2022 w.e.f. January 24, 2022.
[45] Such limits do not apply to Category I AIF/Category II AIF domiciled in IFSC, provided appropriate disclosures have been made in the PPM and the investments by AIFs are in line with the risk appetite of the investors.
[46] Vide SEBI (Alternative Investment Funds) (Third Amendment) Regulations, 2021 w.e.f. August 3, 2021.
[47] SEBI (Alternative Investment Funds) (Fourth Amendment) Regulations, 2018 w.e.f. August 13, 2021.
[48] Vide SEBI (Alternative Investment Funds) (Second Amendment) Regulations, 2021 w.e.f. August 5, 2021.

5. AIF shall not invest in associates or in units of other AIFs managed or sponsored by its Manager, Sponsor or associates of its Manager or Sponsor, except with the approval of 75% of investors by value of their investment in the AIF.
6. Except with the approval of 75% of the investors by value of their investment in the scheme of AIF, an AIF scheme shall not buy or sell investments, from/to associates or schemes of AIFs managed/ sponsored by its Manager, Sponsor or associates of its Manager/ Sponsor. Further the AIF should not buy or sell investments from/to an investor who has committed to invest at least 50% of the corpus of the scheme, and such investor must be excluded from the voting process while getting the necessary approval.[49]
7. Un-invested portion of the investable funds and divestment proceeds pending distribution to investors may be invested in liquid mutual funds or bank deposits or other liquid assets of higher quality such as Treasury bills, Triparty Repo Dealing and Settlement, Commercial Papers, Certificates of Deposits, etc. till the deployment of funds as per the investment objective, or the distribution of the funds to investors as per the terms of the fund documents.[50]
8. AIF may act as Nominated Investor as specified in SEBI (Issue of Capital and Disclosure Requirements) Regulations. This is in connection with public issues made by SME companies.
9. Investment by Category I and Category II AIFs in the shares of entities listed on institutional trading platform (SMEs) shall be deemed to be investment in 'unlisted securities'.
10. AIFs are required to hold their investments in dematerialised form, subject to conditions specified by SEBI from time to time. However, condition for holding investments in dematerialisation form does not apply in the following cases:[51]
    a. investments by AIFs in such type of instruments which are not eligible for dematerialisation
    b. investments held by a liquidation scheme of the AIFs that are not available in the dematerialised form
    c. such other investments by AIFs and such other schemes of AIFs as may be specified by the SEBI from time to time

4.1.10 Specific Investment Conditions for Category I AIFs

The below investment conditions are applicable to all Category I Alternative Investment Funds:

[49] Vide SEBI (AIF) (Second Amendment) Regulations, 2023 w.e.f. June 15, 2023.
[50] Vide SEBI (Alternative Investment Funds) (Fourth Amendment) Regulations, 2018 w.e.f. August 13, 2021.
[51] Vide SEBI (AIF) (Amendment) Regulations, 2024 w.e.f. January 5, 2024.

1. Category I AIF shall invest in investee companies, venture capital undertakings (VCU), special purpose vehicles, limited liability partnerships, units of other Category I AIFs of the same sub-category or scheme or in units of Category II AIFs.[52]
2. Category I AIFs may engage in hedging, including credit default swaps in terms of the conditions as may be specified by SEBI from time to time.[53]
3. Category I AIFs are not permitted to borrow funds either directly or indirectly or engage in any leverage for the purpose of making investments, except for meeting temporary funding requirements and day-to-day funding requirements for not more than 30 days, on not more than 4 occasions in a year and not more than 10% of the investable funds.[54]
4. In order to facilitate ease of doing business and provide operational flexibility, Category I AIFs are allowed to borrow for the purpose of meeting temporary shortfall in amount called from investors for making investments in investee companies ('drawdown amount'), subject to fulfilment of additional conditions specified by SEBI.[55] Further, all Category I AIFs shall maintain 30 days cooling off period between two periods of borrowing as permissible under SEBI (AIF) Regulations. The cooling off period shall be calculated from the date of repayment of previous borrowing.

In addition to the above, the following investment conditions are applicable for **Venture Capital Funds** (VCF):

1. At least 75% of the investable funds shall be invested in unlisted equity shares or equity linked instruments of a VCU or in companies listed or proposed to be listed on a SME exchange or SME segment of an exchange.[56]
2. Venture Capital funds may enter into an agreement with merchant banker to subscribe to the unsubscribed portion of the issue or to receive or deliver securities in the process of market making for SME issues, as per Chapter IX of the SEBI (Issue of Capital and Disclosure Requirements) Regulations.
3. Venture Capital funds shall be exempt from sub-regulations (1) and (2) of regulation 3 and sub-regulation (1) of regulation 4 of SEBI (Prohibition of Insider Trading) Regulations, 2015 in respect of investment in companies listed on SME Exchange or SME segment of an exchange pursuant to due diligence of such companies subject to the following conditions:[57]

[52] SEBI (Alternative Investment Funds) (Second Amendment) Regulations, 2021 w.e.f. May 5, 2021.
[53] Vide SEBI (AIF) (Amendment) Regulations, 2023 w.e.f. January 9, 2023.
[54] Vide SEBI (AIF) (Fourth Amendment) Regulations, 2024 w.e.f. August 7, 2024.
[55] SEBI Circular No.: SEBI/HO/AFD/AFD-POD-1/P/CIR/2024/112 dated August 19, 2024 on Guidelines for borrowing by Category I and Category II AIFs and maximum permissible limit for extension of tenure by LVFs.
[56] SEBI (Alternative Investment Funds) (Second Amendment) Regulations, 2018 w.e.f. August 13, 2021.
[57] SEBI (Alternative Investment Funds) (Fourth Amendment) Regulations, 2018, w.e.f. August 13, 2021.

a. the fund shall disclose any trading in securities pursuant to such due-diligence, within two working days of such trading, to the stock exchanges where the investee company is listed;
b. such investment shall be locked in for a period of one year from the date of investment.

The following specific additional conditions shall apply to **SME Funds**:

1. At least 75% of the investable funds shall be invested in unlisted securities or partnership interest of VCUs or investee companies which are SMEs or in companies listed or proposed to be listed on SME exchange or SME segment of an exchange, or in units of Category II AIFs which invest primarily in such venture capital undertakings or investee companies.[58]
2. These funds may enter into an agreement with merchant banker to subscribe to the unsubscribed portion of the issue or to receive or deliver securities in the process of market making for such issues, as per Chapter IX of the SEBI (Issue of Capital and Disclosure Requirements) Regulations.
3. SME funds shall be exempt from sub-regulations (1) and (2) of regulation 3 and sub-regulation (1) of regulation 4 of SEBI (Prohibition of Insider Trading) Regulations, 2015 in respect of investment in companies listed on SME Exchange or SME segment of an exchange pursuant to due diligence of such companies subject to the following conditions:
    a) the fund shall disclose any trading in securities pursuant to such due-diligence, within two trading days of such trading, to the stock exchanges where the investee company is listed;
    b) such investment shall be locked in for a period of one year from the date of investment.

The following additional specific conditions shall apply to **Social Impact Funds**:

1. At least 75% of the investable funds shall be invested in unlisted securities or partnership interest of social ventures or in units of social ventures or in securities of social enterprises. An existing social impact fund may invest the remaining investable funds in securities of not for profit organizations registered or listed on a social stock exchange with the prior consent of at least 75% of the investors by value of their investment.[59]
2. These funds may accept grants, provided that such utilisation of such grants shall be as per the condition stated above and the minimum grant from any person shall not be less than INR 10 lakh. However, the minimum amount of grant shall not be

[58] SEBI (Alternative Investment Funds) (Fourth Amendment) Regulations, 2018, w.e.f. August 13, 2021.
[59] Vide SEBI (AIF) (Third Amendment) Regulations, 2022 w.e.f. July 25, 2022.

applicable to accredited investors.[60] No profits or gains may be attributed to the provider of such grants.

3. A social impact fund or schemes of a social impact fund launched exclusively for a not for profit organization registered or listed on a social stock exchange, shall be permitted to deploy or invest 100% of the investable funds in the securities of not for profit organizations registered or listed on a social stock exchange.[61]
4. Such funds may give grants to social ventures or social enterprises, provided that appropriate disclosure is made in the PPM.

The following additional specific conditions shall apply to **Infrastructure Funds**:

1. At least 75% of the investable funds shall be invested in unlisted securities or units or partnership interest of VCUs or investee companies or special purpose vehicles, which are engaged in or formed for the purpose of operating, developing or holding infrastructure projects, or in units of Category II AIFs which invest primarily in such venture capital undertakings or investee companies or special purpose vehicles.
2. Notwithstanding the restriction stated in above point, Infrastructure funds may also invest in listed securitised debt instruments or listed debt securities of such investee companies or special purpose vehicles which are engaged in or formed for the purpose of operating, developing or holding infrastructure projects.

4.1.11 Specific Investment Conditions for Category II AIFs

1. Category II AIFs shall invest primarily in unlisted investee companies, directly or through investment in units of other AIFs. Category II AIFs shall invest in investee companies or in the units of other Category I or Category II AIFs as may be disclosed in the placement memorandum.[62]
2. Category II AIFs are not permitted to borrow funds either directly or indirectly or engage in any leverage for the purpose of making investments, except for meeting temporary funding requirements and day-to-day operational requirements for not more than 30 days, on not more than 4 occasions in a year and not more than 10% of the investable funds. However, Category II AIFs may engage in hedging , subject to guidelines as may be specified by SEBI from time to time.
3. In order to facilitate ease of doing business and provide operational flexibility, Category II AIFs are allowed to borrow for the purpose of meeting temporary shortfall in amount called from investors for making investments in investee companies ('drawdown amount'), subject to fulfilment of additional conditions

[60] SEBI (Alternative Investment Funds) (Fourth Amendment) Regulations, 2018, w.e.f. August 13, 2021.
[61] Vide SEBI (AIF) (Third Amendment) Regulations, 2022 w.e.f. July 25, 2022.
[62] SEBI (Alternative Investment Funds) (Second Amendment) Regulations, 2021 w.e.f. May 5, 2021.

specified by SEBI. Further, all Category II AIFs shall maintain 30 days cooling off period between two periods of borrowing as permissible under SEBI (AIF) Regulations. The cooling off period shall be calculated from the date of repayment of previous borrowing.

4. Category II AIFs may buy or sell credit default swaps in terms of the conditions as may be specified by SEBI.[63]
5. Category II AIFs may enter into agreement with merchant banker to subscribe to the unsubscribed portion of the issue or to receive or deliver securities in the process of market making, as per Chapter IX of the SEBI (Issue of Capital and Disclosure Requirements) Regulations, 2018.
6. Category II AIFs shall be exempt from sub-regulations (1) and (2) of regulation 3 and sub-regulation (1) of regulation 4 of SEBI (Prohibition of Insider Trading) Regulations, 2015 in respect of investment in companies listed on SME Exchange or SME segment of an exchange pursuant to due diligence of such companies, subject to the following conditions:
    i. the fund shall disclose any trading in securities pursuant to such due-diligence, within two trading days of such trading, to the stock exchanges where the investee company is listed
    ii. such investment shall be locked in for a period of one year from the date of investment.

4.1.12 Special Dispensation for Angel Funds

SEBI has stipulated a special dispensation for Angel Funds as a sub-category of Category I AIF. This is because angel investments are made at a very early stage in the life cycle of a business and require more flexibility.

Essentially angel investors are high net worth individuals (HNIs) who invest in their individual capacity or through their family offices with own funds. Typically, angel investors seek equity representation in a start-up with the intention of exiting only if and when the venture succeeds. Since such businesses entail high risk of mortality, the term 'angel investor' was coined in USA to describe them more as benefactors and less as commercial investors. In most situations, start-up ventures find it difficult to establish the required confidence for VC funds to invest or banks to lend to them. Therefore, angels take the high risk and address the critical financing gap in the initial formative phase of a start-up business venture.
According to the AIF Regulations, an angel investor is defined as

i. an individual investor who has net tangible assets of at least INR 2 crore excluding value of his principal residence, and who has early stage investment experience, or has experience as a serial entrepreneur or is a senior management professional with

[63] Vide SEBI (AIF) (Amendment) Regulations, 2023 w.e.f. January 9, 2023.

at least ten years of experience. (Further, early stage investment experience is defined as prior experience in investing in start-up or emerging or early-stage ventures and 'serial entrepreneur' shall mean a person who has promoted or co-promoted more than one start-up venture.); or

ii. a body corporate with a net worth of at least INR 10 crore; or

iii. an AIF registered under SEBI (AIF) Regulations, 2012 or Venture Capital Fund (VCF) registered under the SEBI (VCF) Regulations, 1996.

In recent years, angel investment has also got organised whereby fund managers have started angel funds to pool capital from high net worth angel investors so as to bring the advantage of active fund management to angel stage investments. Angel funds typically have the same organisational structure and similar investment processes as those described for venture capital and private equity funds. An angel fund is defined under the Regulations as a sub-category of venture capital fund under Category I- AIF that raises funds from angel investors and invests in accordance with the provisions of Chapter III-A of SEBI (AIF) Regulations.

1. **Formation and Corpus Creation** - An Angel Fund requires to be registered specifically as an angel fund with SEBI though it is a sub-category of Category I AIF. Any registered Category I AIF that has not made any investments may apply to SEBI for conversion of its category into an Angel Fund. Angel funds shall raise funds only by issuing units to angel investors through private placement by issue of PPM. An angel fund shall have a corpus of at least INR 5 crore. It shall accept, up to a maximum period of five years, an investment of not less than INR 25 lakh from a single angel investor.
2. **Schemes and Listing –** Angel Funds may launch schemes subject to filing of a term sheet with SEBI, containing material information regarding the scheme, in the format and time period as may be specified by SEBI. No scheme of the angel fund shall have more than 200 angel investors (if it is a company, it shall be subject to the Companies Act 2013). Units of angel funds shall not be listed on any recognised stock exchange.
3. **Investment Restrictions** –
   i. Angel funds shall invest in start-ups which:
      a. are not promoted or sponsored by or related to an industrial group whose group turnover exceeds INR 300 crore.[64]
      b. are not companies with family connection with any of the angel investors who are investing in the company.
   ii. Investment by an angel fund shall not be less than INR. 25 lakh and shall not exceed INR 10 crore.
   iii. Investment by an angel fund shall be locked-in for a period of one year.

[64] Industrial group includes a group of body corporates with the same promoter(s)/ promoter group, a parent company and its subsidiaries, a group of body corporates in which the same person/ group of persons exercise control, and a group of body corporates comprised of associates/ subsidiaries/ holding companies.

iv. Angel funds shall not invest in associates. As per SEBI (AIF) Regulations, an associate means a company or a limited liability partnership or a body corporate in which a director or trustee or partner or Sponsor or Manager of the AIF or a director or partner of the Manager or Sponsor holds, either individually or collectively, more than fifteen percent of its paid-up equity share capital or partnership interest.
v. Angel funds shall not invest more than 25% of the total investments under all its schemes in a single entity, provided that the compliance to this sub-regulation shall be ensured by the Angel Fund at the end of its tenure.
vi. An angel fund may also invest in the securities of companies incorporated outside India subject to conditions or guidelines issued by the RBI and SEBI from time to time.
vii. The manager or sponsor shall have a continuing interest in the angel fund of not less than 2.5% of the corpus or INR 50 lakh, whichever is lesser, and such interest shall not be through the waiver of management fees
viii. Prior to making investments, the manager of the angel fund shall obtain prior approvals from the angel investors.

4.1.13 Special Dispensation for Special Situation Funds[65]

SEBI has stipulated a special dispensation for Special Situation Funds (SSF) as a sub-category of Category I AIF. This is because special situation funds can play a vital role to decrease the impact of bad loans on banks. In this regard, SEBI has detailed out certain exemptions for SSFs from investment concentration norm in a single investee company and permitting to invest its investable funds in unlisted or listed securities of the investee company.

"Special Situation fund" means a Category I AIF that invests in special situation assets in accordance with its investment objectives and may act as a resolution applicant under the Insolvency and Bankruptcy Code (IBC), 2016. Special situation asset includes:

a. Stressed Loans available for acquisition in terms of Clause 58 of Master Direction – RBI (Transfer of Loan Exposure) Directions, 2021 or as part of a resolution plan approved under the Insolvency and Bankruptcy Code, 2016, or in terms of any other policy of the RBI or Government of India.[66]
b. Security Receipts issued by an Asset Reconstruction Company (ARC) registered with the RBI

[65] Vide SEBI (Alternative Investment Funds) (Amendment) Regulations, 2022 w.e.f. January 24, 2022.
[66] As per Clause 58 of the Master Direction, acquisition of stressed loans can be done by permitted entities and Asset Reconstruction Companies ("ARCs") as a part of resolution plan under the Reserve Bank of India (Prudential Framework for Resolution of Stressed Assets) Directions, 2019, resulting in an exit of all lenders. The Master Circulars also lays down conditions of transfer to non-permitted entities.

c. Securities of investee companies whose stressed loans are available for acquisition in terms of RBI's Master Direction or as part of a resolution plan approved under the Insolvency and Bankruptcy Code, 2016
d. Securities of investee companies against whose borrowings, security receipts have been issued by an ARC or whose borrowings are subject to corporate insolvency resolution process under Insolvency and Bankruptcy Code, 2016. The credit rating of such borrowings should be downgraded to "D" or equivalent.
e. Securities of investee companies who have disclosed defaults relating to interest and principal payments on loans from banks, financial institutions, non-banking financial companies and debt securities, in terms of SEBI (Issue of Capital and Disclosure Requirements) Regulations, 2018 and such payment default is continuing for at least ninety calendar days after the occurrence of such default. The credit rating of such loans and debt securities should be downgraded to "D" or equivalent.

Investment in Special Situation Funds (SSF):

- Each scheme of a special situation fund shall have a minimum corpus of INR 100 crore.[67]
- The minimum investment by an investor in an SSF should be INR 10 crore and INR 5 crore in case of an Accredited Investor. In case of investments by employees or directors of the SSF, or employees or directors of investment manager of the SSF, the minimum amount of investment should be INR 25 lakh.
- The special situation fund shall not accept investments from any other AIF, other than a special situation fund.

Investment by Special Situations Funds (SSF):

Special Situation Funds shall invest only in special situation assets and may act as a resolution applicant under the Insolvency and Bankruptcy Code, 2016. An SSF intending to act as a Resolution Applicant shall ensure compliance with the eligibility requirements, as per the Insolvency and Bankruptcy Code, 2016.

A Special Situation Fund should not invest in its associates, or in the units of any other Alternative Investment Fund (except in units of a special situation fund), or in units of special situation funds managed or sponsored by its manager, sponsor or associates of its manager or sponsor.

In case a Special Situation Fund (SSF) acquires stressed loans, in terms of Clause 58 of Master Direction – RBI (Transfer of Loan Exposure) Directions, 2021:

[67] Vide SEBI Circular No. SEBI/HO/IMD-I/DF6/P/CIR/2022/009 dated January 27, 2022 on Introduction of Special Situation Funds as a sub-category under Category I AIFs.

- The fund can acquire stressed loans in terms of afore-mentioned clause, upon inclusion of SSF in the respective Annex of the RBI Master Direction
- The stressed loans acquired shall be subject to a minimum lock-in period of 6 months. The lock in period shall not be applicable in case of recovery of the stressed loan from the borrower
- The fund acquiring stressed loans shall comply with the same initial and continuous due diligence requirements for investors, as those mandated by RBI for investors in an Asset Reconstruction Company.

4.1.14 General Obligations and Responsibilities of a Category I and Category II AIFs[68]

As per SEBI (AIF) Regulations, all AIFs shall have the following general obligations:

- All Category I and Category II AIFs shall inform SEBI any material change from the information provided by the Fund in the PPM, at the time of application for registration. All changes in terms of the PPM and in the documents of the Category I AIFs and Category II AIFs shall be intimated to its investors and SEBI on a consolidated basis, within 1 month of the end of each financial year. The intimation shall specifically mention the changes carried-out in the PPM and the documents of the Category I AIFs and Category II AIFs, along-with the relevant pages of revised sections/clauses.[69]

- The above-mentioned intimation to SEBI for change in terms of the PPM shall be submitted through a merchant banker, along with the due diligence certificate.[70] However, SEBI has recently notified that changes in a few specified terms of PPM can be filed directly to SEBI.[71]

- In case of change of Sponsor or Manager or change in control of the Category I AIF and Category II AIF, Sponsor or Investment Manager of the fund, prior approval from SEBI must be taken by the AIF to carry on investment activities.[72]

[68] Vide SEBI (Alternative Investment Funds) (Second Amendment) Regulations, 2021 w.e.f. May 5, 2021.
[69] Vide SEBI Circular No. SEBI/HO/IMD/IMD-I/DOF6/CIR/2021/549 dated April 07. 2021 on Regulatory reporting by AIFs.
[70] As per Annexure B of the 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.
[71] SEBI Circular No.: SEBI/HO/AFD/PoD/CIR/2024/028 dated April 29, 2024 on Relaxation in requirement of intimation of changes in the terms of PPM of AIFs through Merchant Banker.
[72] SEBI vide Circular No.: SEBI/HO/IMD-1/DF9/CIR/2022/032 dated March 23, 2022 on Change in control of Sponsor and/or Manager of Alternative Investment Fund involving scheme of arrangement under Companies Act, 2013 has detailed out the process for providing approval to a proposed change in control of the Sponsor and/or Manager of the AIF involving scheme of arrangement which needs sanction of National Company Law Tribunal (NCLT) in terms of the provisions of the Companies Act, 2013.

- The Manager and either the trustee or trustee company or designated partners or directors of the fund, shall ensure compliance with the Code of Conduct, by such fund.

- All Category I AIF/Category II AIF 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 (AIF) Regulations, terms of the PPM, agreements made with investors, other fund documents and applicable laws.

- All 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 I AIF/Category II AIF.

- The books of accounts of the Category I AIF and Category II 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 SEBI (Portfolio Managers) Regulations, 2020, for investment in securities of investee companies when the Category I AIF/ Category II AIF managed by such manager makes an investment.[73]

- The Manager shall appoint a Compliance Officer who shall be responsible for monitoring compliance with all relevant regulations and circulars issued by SEBI.

- The Sponsor or Manager of the AIF shall appoint a Custodian registered with SEBI for safekeeping of the securities of the AIF.[74]

4.1.15 Code of Conduct

The Category I AIF/ Category II 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 shall abide by the Code of Conduct specified in Fourth Schedule of the SEBI (Alternative Investment Funds) Regulations, as follows:

[73] SEBI (Alternative Investment Funds) (Fifth Amendment) Regulations, 2021 w.e.f. December 8, 2021.
[74] Vide SEBI (AIF) (Amendment) Regulations, 2024 w.e.f. January 5, 2024.

For this purpose, "key management personnel" shall mean:[75]

- members of key investment team of the Manager, as disclosed in the PPM of the fund
- employees involved in decision making on behalf of the AIF, including but not limited to, members of senior management team at the level of Managing Director, Chief Executive Officer, Chief Investment Officer, Whole Time Directors, or such equivalent role or position
- any other person whom the AIF (through the Trustee, Board of Directors or Designated Partners, as the case may be) or Manager may declare as key management personnel.

The Category I AIF/ Category II AIF should disclose the name of all the key managerial personnel of the AIF and the investment manager in the private placement memorandum. Any change in the key managerial personnel shall be intimated to the investors and SEBI.

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 (AIF) Regulations, to all investors.
d) Ensure the dissemination of any other information as agreed with the investors.
e) Ensure that an effective risk management process and appropriate internal controls are in place.
f) Have written policies and procedures to identify, monitor and appropriately mitigate any potential conflict of interest through-out the scope of its business.
g) Not use any unethical means to sell, market or induce any investor to buy its units.
h) Have written policies and procedures to comply with anti-money laundering laws.

II. Code of Conduct for the Managers of Category I AIF/ Category II AIF and key management personnel of Managers and Category I AIF/ Category II AIF

Every Manager of an Category I AIF/ Category II AIF and key management personnel of the manager and fund shall:

[75] Vide SEBI Circular No.: SEBI/HO/IMD-I/DF6/P/CIR/2021/584 dated June 25, 2021 on Amendment to SEBI (AIF) Regulations, 2012.

a) Abide by the Act, Rules, Regulations, Guidelines and Circulars as applicable to Category I AIF/ Category II AIF at all times.
b) Maintain integrity, highest ethical and professional standards in all its dealings.
c) Ensure proper care and exercise due diligence and independent professional judgement in all its decisions.
d) Act in a fiduciary capacity towards investors of the Category I AIF/ Category II AIF and ensure that decisions are taken in the interest of the investors.
e) Abide by the policies of the Category I AIF/ Category II 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 I AIF/ Category II AIF, if they have committed to the transactions on behalf of Fund.
m) Maintain ethical standards of conduct and deal fairly and honestly with investee companies at all times.
n) Maintain confidentiality of information received from investee companies and companies seeking investments from the Category I AIF/ Category II AIF, unless explicit confirmation is received that such information is not subject to any non-disclosure agreement.

III. Code of Conduct for the Members of the Investment Committee, trustee, trustee company, directors of the trustee company, directors or designated partners of the Category I/ Category II AIF

Members of the Investment Committee, trustee, trustee company, directors of the trustee company, directors or designated partners of the Category I AIF/ Category II 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 I AIF/ Category II 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 I AIF/ Category II 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.

4.1.16 Exemption from enforcement of the regulations in special cases[76]

A Category I AIF/Category II AIF, a person or a class of persons may be exempt from the enforcement of any or all provisions of the SEBI (Alternative Investment Funds) Regulations, for a period not exceeding twelve months. This may be done for improving innovation, testing new products, processes, services or business models, in a live environment of regulatory sandbox in the securities markets.[77] 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.

4.2 General Provisions of the Foreign Exchange Management Act 1999

4.2.1 FDI and its Economic Significance

It may be appreciated that India is a consumption-oriented economy and imports a large part of its oil requirements apart from gold, steel, several other commodities, capital goods, intermediate goods and consumption goods. As a result, for a long time, India has had an adverse balance of payment position in international trade i.e. imports were more than exports. Traditionally, due to this adverse position, India had a shortage of free foreign exchange (internationally convertible foreign exchange). The Foreign Exchange Regulation

[76] Inserted by SEBI (Regulatory Sandbox) (Amendment) Regulations, 2020 w.e.f. April 17, 2020 and amended by SEBI (Regulatory Sandbox) (Amendment) Regulations, 2021, w.e.f. August 3, 2021.
[77] Regulatory sandbox means a live testing environment where new products, processes, services, business models, etc. may be deployed on a limited set of eligible customers for a specified period of time, for furthering innovation in the securities market, subject to such conditions as may be specified by SEBI.

Act introduced in 1947 was later replaced with the Foreign Exchange Regulation Act, 1973 (FERA), which came into effect on 1st Jan, 1974.

It was in 1991 that India faced a foreign exchange crisis and required a bail out from external resources. As a part of the bail-out conditions stipulated by the International Monetary Fund (IMF), the government initiated the process of liberalisation of Indian economy in 1991. The larger objective was to bring in a market-oriented economy and invite foreign capital into the country for long term investment. The requirement for foreign capital to finance India's economic investments is well-recognised from then on in government policy-making.

After the liberalisation of foreign investment policy in 1991, foreign direct investment or FDI was permitted in various sectors. Foreign investment is defined as "any investment made by a person resident outside India on a repatriable basis in capital instruments of an Indian company or to the capital of an LLP". 'Investment on repatriation basis' is an investment, the sale/ maturity proceeds of which are, net of taxes, eligible to be remitted outside India to the foreign beneficiary's account in fully convertible foreign exchange. In the later years, in order to curb the restrictive provisions of FERA, some of which were criminal provisions, the management of foreign exchange and serious economic offences relating to foreign exchange were separated. The administrative provisions of foreign exchange management were enacted into a separate law called the Foreign Exchange Management Act (FEMA) 1999 and serious foreign exchange offences (including money laundering and round tripping) were included in the new Prevention of Money Laundering Act 2002 (PMLA). FEMA was made effective from 1st June, 2000. RBI introduced several liberalised regulations under the FEMA to ease investments by non-residents including NRIs.

Simultaneously, SEBI introduced foreign investment in capital markets and venture capital in India which are currently dealt with under separate policy regulations called Foreign Portfolio Investment (FPI) and Foreign Venture Capital Investors (FVCI) Regulations respectively. The introduction of FDI and FPI and subsequent liberalisations thereof increased flow of foreign exchange to India and foreign exchange reserves increased substantially in later years. Currently, India expects to gain substantially from liberalised FDI and NRI remittances to benefit its economy for investment in critical sectors like infrastructure, large manufacturing, exports, e-commerce, start-ups and services companies that are vital for its growth and development.

Till 1993, the INR was floated only against a basket of international currencies. Progressively, the currency restrictions were eased and the Rupee was made fully convertible on current account, lifting restrictions on day-to-day transactions to a large extent. Though India has considerable foreign exchange reserves presently, the currency is still not convertible fully on capital account (capital receipts and payments) due to the economy's import dependence thereby creating vulnerability for the Rupee. Accordingly, for larger capital account transactions such as investments, borrowings, asset acquisitions and capital goods imports, there is an approval mechanism which is regulated through the EXIM policy, FDI policy and the ECB policy. Genuine hedging transactions in foreign exchange are allowed but there are also regulations to curb currency speculation through OTC and exchange traded forex derivative transactions. In addition, the RBI also intervenes in the foreign exchange market whenever required to prevent excessive fluctuations in the exchange rate of the INR. The Indian currency can thus be called a managed convertible currency.

4.2.2 Investment Framework under FEMA[78]

Investment framework under FEMA relates to regulating cross-border in-bound investments being made in India by non-resident investors and vice versa (foreign investment made by resident investors in India). It is necessary to appreciate that FEMA relies on the concept of 'residence' of an investor to differentiate between domestic and foreign investors and make regulations accordingly. The definition of 'residence' under FEMA need not correspond exactly with that under the Income Tax Act, 1961 in all cases. So investors need to check their residential status under both these laws separately to determine necessary compliance. The relevant regulations under FEMA governs the AIF investments by foreign investors including NRIs and PIOs, downstream FDIs by AIFs in investee companies and AIF investments in overseas investment opportunities. These aspects are discussed in the following paragraphs.

4.2.3 NRIs and PIOs

Non-Resident Indian (NRI) means an individual resident outside India who is a citizen of India and 'Overseas Citizen of India' means an individual resident outside India who is registered as an Overseas Citizen of India Cardholder within the meaning of section 7(A) of the Citizenship Act, 1955. The connotation of NRI under FEMA and the Income Tax Act, 1961 are different. The Income Tax Act, 1961 classifies NRIs under non-residents though under some provisions they are given differential treatment. 'Overseas Citizen of India' – OCI cardholders are deemed to be overseas citizens of India.[79] Thus, a person resident outside India will be 'NRI', if he is either a citizen of India or an OCI cardholder. For the purpose of FEMA, NRI means a person resident outside India who is a citizen of India.

Person of Indian Origin (PIO) means a citizen of any country other than Bangladesh or Pakistan, Afghanistan, China, Iran Bhutan, Sri Lanka and Nepal, if:

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[78] As amended or replaced from time to time

[79] Registered as such under Notification No. 26011/4/98 F.I. dated 19.8.2002 issued by the Central Government.

i) He or she at any time held Indian passport;

ii) His or her parent(s) or any grandparent(s) or any great grandparent(s) was a citizen of India by virtue of the Constitution of India or the Citizenship Act, 1955

iii) The person is a spouse of an Indian citizen or a person

The definition has been modified for various purposes in various regulations.

4.2.4 Residence under FEMA

For the purpose of administration of FEMA, a distinction is made between 'resident' and 'non-resident' person. A person includes an individual, HUF, company, firm, an association of persons, body of individuals (whether incorporated or not), every artificial judicial person and any agency, office or branch owned or controlled by such person as per section 2(u) of FEMA. A person resident in India would be one of the following categories under section 2(v):

1. A person normally residing in India for more than 182 days during the course of preceding financial year. However, it does not include a person who has gone out of India or who stays outside India for employment outside India or carrying on business or vocation outside India or for any other purpose, in such circumstances as would indicate his intention to stay outside India for an uncertain period. Also it does not include a person who has come to or stays in India, in either case, otherwise than to take up any employment or for carrying on any business or vocation or for any other purpose in such circumstances as his intention to stay in India for an uncertain period.
2. Any person or body corporate registered or incorporated in India.
3. An office, branch or agency in India owned or controlled by a person resident outside India.
4. An office, branch or agency outside India owned or controlled by a person resident in India.

It may be noted that under FEMA, the intention of stay is pertinent to prove residence but under the Income Tax Act, 1961, the physical stay is important to decide residence.

4.2.5 Investments by NRIs and PIOs

The Indian non-resident community constitutes an important source of foreign exchange for the Indian economy. NRIs and PIOs have been given some special preferences/ facilities for investment in India. These are in addition to foreign investment routes available to non-resident investors. As far as financial investments are concerned, NRIs have been provided the facility to invest in several investment options on a fully repatriable basis (i.e. they can invest and take back the capital and returns thereon in foreign exchange) and on a non-repatriable basis. Investment options include direct investments under the FDI route, government dated securities/ treasury bills, units of domestic mutual funds, bonds issued by a Public Sector Undertakings (PSUs) in India, shares in a PSUs (dis-invested by Government of India), shares and convertible debentures permitted to be invested under the FDI policy, shares and debentures of Indian companies, public deposits with Indian companies including Non-Banking Finance Companies (NBFCs), Housing Finance Corporations (HFCs) and other financial institutions and investments in investment vehicles such as AIFs registered with SEBI. Investments by NRIs / PIOs are regulated by the FDI policy read with the Master Directions and the Rules issued by RBI from time to time (these are explained in the following paragraph). NRIs along with other categories of non-residents such as PIOs and OCIs are allowed to invest in AIFs registered with SEBI under the FDI policy.

4.2.6 Inbound Foreign Investment Routes

Foreign investments in India can be classified under three different routes described below, apart from investment through the AIF route.

1. **FDI Route** – All non-resident investments which are strategic in nature, i.e. for a business or long term investment purpose make use of the Foreign Direct Investment (FDI) route. For the purpose of being classified as foreign direct investment, the size of the investment shall not be less than 10% of the post-investment fully diluted paid-up capital of the investee company. The FDI policy is issued from time to time by the DPIIT, Ministry of Commerce and Industry and Government of India. It is operationalised by the RBI under FEMA through the Foreign Exchange Management (Non- Debt Instrument) Rules ('NDI Rules') and the modalities and operational directions are issued under the FEMA Master Directions (both as amended from time to time).

   The FDI policy read with the NDI Rules and Master Directions deals with prohibited sectors for FDI, permitted sectors with sectoral caps (i.e. the maximum FDI approved in the paid-up capital of an investee company in a given sector), type of securities that can be issued, investments that can be made under automatic route without prior permissions from RBI or the government, investments that require prior government and RBI approval, minimum capitalisation norms in select cases, pricing regulations for the issue of securities by Indian companies to non-resident investors, subsequent sale or transfer of such securities by non-residents and all incidental matters connected to foreign investments.

2. **FPI Route** – The Foreign Portfolio Investment (FPI) route is available to non-resident investors wherein the size of such investment shall not be more than 10% of the post-investment fully diluted paid-up capital of the listed Indian investee company. Such

investments can be made in listed companies on the stock market or through private placements and other available routes. FPIs need to be registered with SEBI prior to commencing investment activity and such persons can be institutional or non-institutional investors. Such registration with SEBI shall be in accordance with the SEBI (Foreign Portfolio Investors) Regulations, 2019. The registration with SEBI will provide the necessary rules and regulations to be followed for FPI activity. In addition, the modalities for FPI investments under FEMA are covered in the Master Directions and the NDI Rules of RBI.

3. **FVCI Route** – The Foreign Venture Capital Investment (FVCI) route is available to off-shore funds that seek to make venture capital investments in eligible unlisted investee companies in India. FVCI funds need to be registered with SEBI prior to commencing investment activity under the SEBI (Foreign Venture Capital Investors) Regulations 2000. The registration with SEBI will provide the necessary rules and regulations to be followed for FVCI activity. In addition, the modalities for FVCI investments under FEMA are covered in the Master Directions and NDI Rules of RBI. FVCIs are allowed to invest only in stipulated priority sectors such as bio-technology, infrastructure etc. except in the case of start-ups which can be from any sector.

   An FVCI can also acquire units of a Category I AIF or any scheme therein. An FVCI may also invest in securities on a recognised stock exchange subject to the provisions of the SEBI (FVCI) Regulations, 2000. This includes receiving the proceeds of the liquidation of such schemes or funds. The pricing for such transactions relating to acquisition/ transfer securities/ instruments is not regulated and they can be at a price that is mutually acceptable to the buyer and the seller/ issuer.

4.2.7 Foreign Investments in AIFs

The NDI Rules, defines an 'Investment Vehicle' to mean an entity registered and regulated under relevant regulations framed by SEBI or any other authority designated for the purpose and shall include (i) Real Estate Investment Trusts governed by the SEBI (Real Estate Investment Trusts) Regulations, 2014, (ii) Infrastructure Investment Trusts governed by the SEBI (Infrastructure Investment Trusts) Regulations, 2014; and (iii) Alternative Investment Funds governed by the SEBI (Alternative Investment Funds) Regulations, 2012.

Further, the NDI Rules defines 'unit' to mean beneficial interest of an investor in the Investment Vehicle.

Foreign investors may make purchase or redemption of units issued by an Indian Category I AIF/ Category II 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. However, the Automatic Route is unavailable for investments in some sectors and for investments above established thresholds in some sectors. When the Automatic Route is unavailable, the foreign investor must obtain prior permission from the sector-specific competent authorities, known as the Approval Route. In case of doubt as to which competent authority is to be approached, the DPIIT is mandated to identify the competent authority concerned and hence, the DPIIT has established a Foreign Investment Facilitation Portal (FIFP).

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.

Rule 6 (c) of the NDI Rules, permits a person resident outside India, as defined earlier, to acquire, purchase, hold, sell or transfer units of an Investment Vehicle, in the manner and subject to the terms and conditions specified in Schedule VIII of the NDI Rules. A non-resident investor can also acquire units of the AIF against the swap of the equity instruments of the Special Purpose Vehicle (SPV) proposed to be acquired by the AIF.

The terms and conditions laid down under such Schedule VIII of the NDI Rules and the FEMA (Mode of Payment and Reporting of Non-debt Instruments) Regulations, 2019 are as under:

- The payment for acquisition of the units of the AIF is to be done by normal banking channel or out of funds held in Non-Resident External (NRE) account or Foreign Currency Non-Resident (B) (FCNR) account. The payment for the units of a Category I AIF/Category II 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.[80]
- An investor who has acquired or purchased units in accordance with NDI Rules may sell or transfer in any manner or redeem the units as per regulations framed by SEBI or directions issued by RBI.
- Downstream Investment is an investment made by an Indian Investment Vehicle in a domestic company, where more than 51 percent investors in the Indian Investment Vehicle are foreign investors. Ordinarily, such investments made by the Investment Vehicle are considered to be “Indirect Foreign Investments” and are subject to the FDI restrictions therein.

[80] As per Foreign Exchange Management (Mode of Payment and Reporting of Non-Debt Instruments) Regulations, 2019.

- Downstream investment by the AIF shall be regarded as indirect foreign investment for the investee Indian company if either the sponsor or the manager or the investment manager is not Indian owned or controlled. Provided that for sponsors or managers or investment managers organized in a form other than companies or LLPs, SEBI shall determine whether the sponsor or manager or investment manager is foreign owned and controlled.
- Ownership and control is determined as per the NDI Rules. AIF is a pooled investment vehicle. 'Control' of the AIF should be in the hands of 'sponsors' and 'managers/ investment managers', with the general exclusion to others. In case the 'sponsors' and 'managers/investment managers' of the AIF are individuals, for the treatment of downstream investment by such AIF as domestic, 'sponsors' and 'managers/ investment managers' should be resident Indian citizens.
- The extent of foreign investment in the corpus of the Investment Vehicle will not be a factor to determine as to whether downstream investment of the Investment Vehicle is foreign investment or not.
- Downstream investment by an Investment Vehicle that is reckoned as foreign investment shall have to conform to the sectoral caps and conditions / restrictions, if any, as applicable to the company in which the downstream investment is made as per the FDI Policy and the NDI Rules.
- A Category I AIF/ Category II AIF which has received foreign investment, or made foreign investment abroad, in any previous year or the current financial year, shall file an annual return on the Foreign Liabilities and Assets (FLA), by 15th July of every year, using the Foreign Liabilities and Assets Information Reporting (FLAIR) portal launched by the Reserve Bank of India. Furthermore, a Category I AIF/ Category II AIF with existing direct or indirect foreign investment is required to provide information to the RBI in the Single Master Form (SMF), through the Foreign Investment Reporting and Management System (FIRMS) portal. All Indian entities, including a Category I AIF/ Category II AIF, 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 I AIF/ Category II AIF, and verified, scrutinized and acknowledged or rejected by their respective Authorized Dealer (AD) Banks.
- 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.[81]

[81] As per Foreign Exchange Management (Mode of Payment and Reporting of Non-Debt Instruments) Regulations, 2019.

4.2.8 Overseas Investments by AIFs[82]

Under Regulation 15(1)(a) of SEBI (AIF) Regulations, an alternative investment fund may invest in securities of companies incorporated outside India subject to such conditions or guidelines that may be stipulated or issued by the RBI and SEBI from time to time. In this regard, the RBI has permitted an AIF, registered with SEBI, to invest overseas in terms of its regulations.[83]

SEBI issued detailed guidelines on overseas investments by an AIF, the highlights of which are presented below:

1. AIFs may invest in equity and equity linked instruments only of offshore venture capital undertakings which are not listed on a recognised stock exchange in India or abroad, subject to overall limit of USD 1500 million for all AIFs to be allocated on a first-come-first-served basis.[84]
2. AIFs desirous of making investments in offshore venture capital undertakings shall submit their proposal for investment to SEBI for prior approval. It is clarified that no separate permission from RBI is necessary in this regard. The approval is valid for 4 months to complete all the investments under the sanctioned limit failing which, it shall lapse.[85] In case the applicant does not utilise the limits allocated within the stipulated period, SEBI may allocate such unutilised limit to other applicants.
3. Such investments shall not exceed 25% of the investable funds (capital) of the scheme of the AIF.
4. AIFs shall invest in an overseas investee company, which is incorporated in a country whose securities market regulator is a signatory to the International Organization of Securities Commission's (IOSCO) Multilateral Memorandum of Understanding or a signatory to the bilateral Memorandum of Understanding with SEBI.
5. AIFs shall not 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. a jurisdiction having a strategic Anti-Money Laundering or Combating the Financing of Terrorism deficiencies to which counter measures apply; or

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[82] SEBI Circular No. SEBI/HO/AFD-1/PoD/CIR/P/2022/108 dated August 17, 2022, SEBI Circular No. SEBI/HO/IMD/DF1/CIR/P/2018/103/2018 dated July 03, 2018 and SEBI Circular No. CIR/IMD/DF/7/2015 dated October 1, 2015 on Guidelines on overseas investments and other issues/ clarifications for AIFs/ VCFs.

[83] A.P.(DIR Series) Circulars No.48, 49 and 50 dated December 09, 2014, April 30, 2007 and May 4, 2007 respectively.

[84] Enhanced limit from USD 750 million by notification vide SEBI Circular No.: SEBI/HO/IMD/DF6/CIR/P/2021/565 dated May 21, 2021. Not applicable to Category I AIF/Category II AIF domiciled in IFSC.

[85] SEBI circular no. SEBI/HO/AFD/PoD/CIR/P/2023/137 dated August 04, 2023

   b. 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.

6. These investments would be subject to Foreign Exchange Management (Overseas Investment) Regulations, 2022, including amendments thereof and related directions issued by RBI from time to time.
7. AIFs shall adhere to FEMA, 1999, its Rules, Regulations and Directions issued by the Government/ RBI from time to time.
8. AIFs shall not invest in Joint Venture or Wholly Owned Subsidiary of itself while making overseas investments.
9. AIFs shall comply with all the requirements under RBI guidelines on opening of branches/subsidiaries/Joint Venture /undertaking investment abroad by NBFCs, where more than 50% of the funds of the AIF has been contributed by a single NBFC.
10. AIFs shall transfer/sell the investment in overseas investee company only to the entities eligible to make overseas investments, as per the extant guidelines issued under the FEMA, 1999.

Sample Questions: Chapter 4

1. Which of the following is the minimum stipulated corpus of an AIF scheme?

a. INR 100 crore

b. INR 20 crore

c. INR 50 crore with a maximum of INR 100 crore

d. INR 10 crore with a maximum of INR 20 crore

2. Which of the following is the minimum stipulated accredited investor contribution in a large value fund for accredited investors?

a. INR 70 crore

b. INR 20 crore

c. INR 10 crore

d. INR 1 crore

3. Category I and II AIF schemes shall have a minimum tenure of ______ years.

a. three

b. three to five

c. five

d. seven

4. The corpus of an AIF scheme can be raised from the public by a NFO of units similar to that of a mutual fund. State whether True or False.

a. True

b. False

5. Any change in the investment strategy of an AIF scheme requires the consent of atleast two-thirds of the unit holders in value. State whether True or False.

a. True

b. False

CHAPTER 5: ALTERNATIVE INVESTMENT FUND STRUCTURING

LEARNING OBJECTIVES:

After studying this chapter, you should know about:

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

5.1 Introduction

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

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

5.2 Principle of 'Pooling'

The concept of 'pooling' is central to the formation of any investment management structure and it applies equally in the context of AIFs. When a set of investors having common investment objectives require investment management services, there are primarily two methods of managing the same – (a) Individual Portfolio Management and (b) Pooled Asset Management. Under the former structure, the individual investment corpus of each investor is kept distinct and managed under a portfolio management agreement with the manager. The portfolio manager either has discretion to take the investment decisions from time to time or every decision is advised to the investor who takes the call depending on whether the management terms are discretionary or non-discretionary. Either way, the essential feature of portfolio management is that it is a customised service offered at individual investor level. Therefore, there would be as many investment management outcomes as there are investors.

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

5.3 General 'Pooling' Considerations

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

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

4. Pooling should also be compliant with regulatory requirements of SEBI, foreign investment law and RBI regulations, corporate law and compliance requirements.
5. The structure should not be too complex such that it is perceived to be exploiting regulatory and tax arbitrage and may come under the scrutiny and wrath of regulators. While taking advantage of available options under law, the structure should seem genuine and not to obfuscate the underlying objectives of creation of the pool. From the Indian context, complicated structures are likely to be scrutinised under the General Anti-Avoidance Rules (GAAR) which allows Indian tax authorities to re-characterise transactions on grounds of lack of commercial substance among other things.[86]
6. From an offshore investor perspective, the general principles for deciding on the jurisdiction for pooling an India centric fund are the following –
    a. Since India is one of the high tax jurisdictions in comparison with several other countries, offshore investor prefers to optimise domestic taxation in India on their investment activity. This would partly offset the currency loss they may incur on Indian rupee (INR) depreciation during the investment horizon. Pooling the fund in a jurisdiction that has a good tax treaty with India which would avoid double taxation in India as well as in the investor's country is of primary importance. India has such Double Taxation Avoidance Agreements (DTAAs) with several countries.
    b. Sometimes, a jurisdiction is also chosen if it has a good Bilateral Investment Promotion and Protection Agreement (BIPA) with India (for e.g. Singapore). A BIPA also helps in protecting an investor's financial interests in India in the event of hostilities between the two countries or other repatriation risks. BIPA also generally provides investment incentives to promote mutual interests of both countries.
    c. Investors may also prefer in certain situations to set up their investment vehicle in a jurisdiction that has a globally recognised capital market such as Luxembourg, Singapore, Tokyo etc. Such a step would help to list the investment vehicle in the local stock market or to explore other such strategic opportunities involving the fund vehicle.
    d. Lastly, from a wealth preservation and security perspective, foreign investors may select pooling jurisdictions that may have in addition to tax advantage, a political system, legal framework and enforcement and a stable currency that provide adequate protection for their wealth.

[86]GAAR are a set of rules to ensure that assessees don't resort to tax avoidance/ evasion by setting up complicated structures and practices that do not have any genuine business purpose. GAAR has been briefly explained in Section 12.6. GAAR came into effect from April 01, 2017.

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

5.4 Anatomy of AIF Constitution

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

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

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

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

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

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

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

3. **Alternative 3** – **Company Structure** – A company incorporated under the Companies Act 2013 is the third alternative to house the AIF corpus. This is the least preferred alternative due to its tax inefficiency (it does not provide tax neutrality). Moreover, are subject to numerous governance and compliance requirements under the Companies Act, 2013, especially if there are public limited companies. Companies

are also restricted in making private placements to not more than 200 investors though the AIF regulations permit the fund or a scheme to have up to 1000 investors.

Almost all AIFs formed in India follow the trust structure because of its operational advantages and favourable regulatory framework. It reduces the cost of compliance and provides flexibility for the AIF to form its own system of governance and reporting.

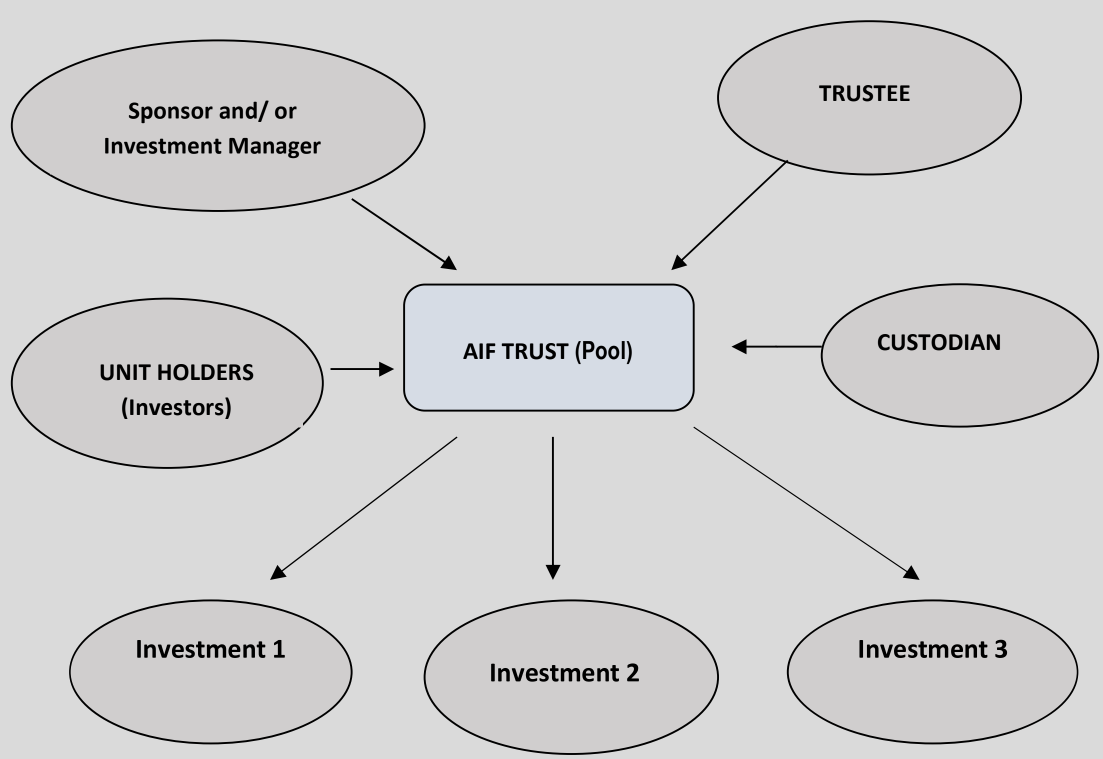
5.5 Templates for AIF Structuring

In this section, we examine the different alternatives that can be used by a domestic AIF and by an offshore Fund or offshore investors wanting to invest in Indian alternative investment funds.

5.5.1 Pure Domestic AIF

A pure domestic AIF would consist of an AIF pool incorporated in India and registered under the SEBI (AIF) Regulations, all the investors being residents of India for FEMA and tax purposes, and the investment manager, sponsor being Indian (see Figure 5.1).

Figure 5.1 – Domestic AIF Trust Structure

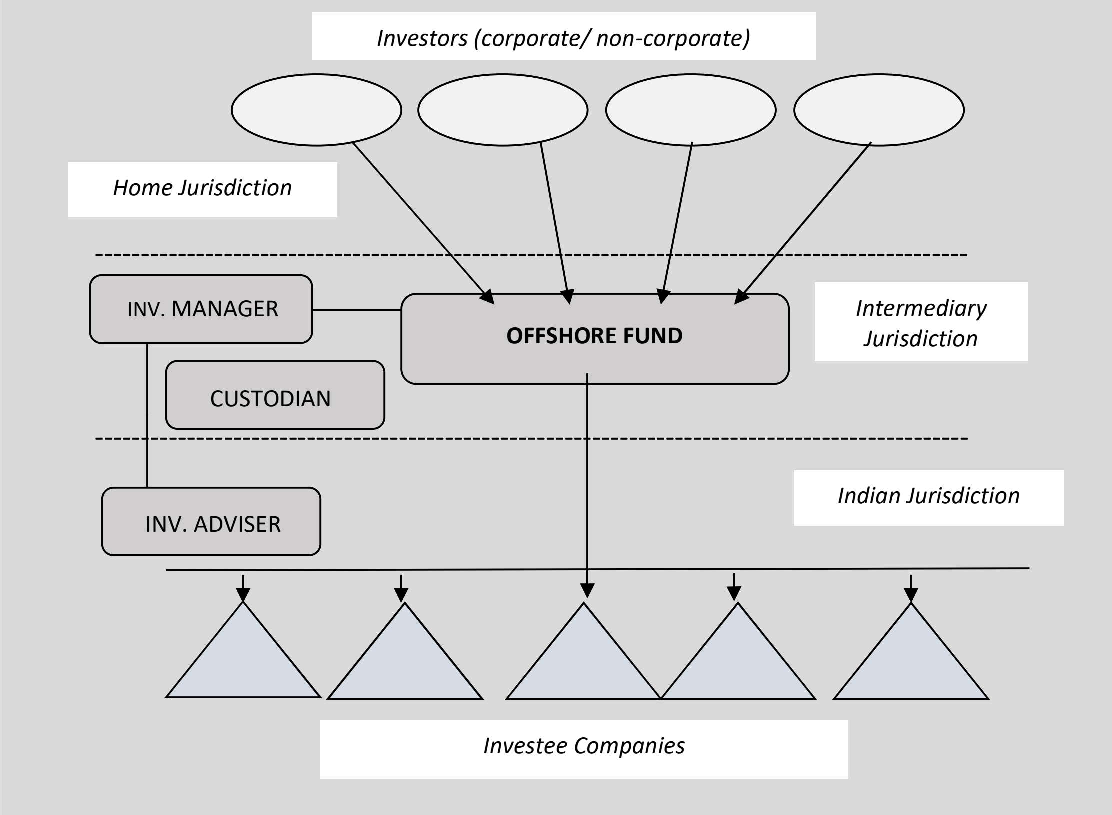


Under the pure domestic fund structure, the AIF trust is incorporated under the Indian Trusts Act 1882 as an irrevocable determinate trust. All the stakeholders as shown in the above exhibit are resident entities in India. The fund is typically invested in India but as allowed under FEMA Regulations, the AIF may choose to invest in overseas assets as well. Since the unit holders are resident Indians (i.e. individuals/ HUFs/ Companies/ LLPs/ Trusts), all transactions, subscriptions and distributions are made domestically in INR.

5.5.2 Pure Offshore Fund

A pure offshore structure would apply when the fund is incorporated outside India and is managed offshore. The structure would appear as follows in Figure 5.2:

Figure 5.2 – Pure Offshore Fund Structure

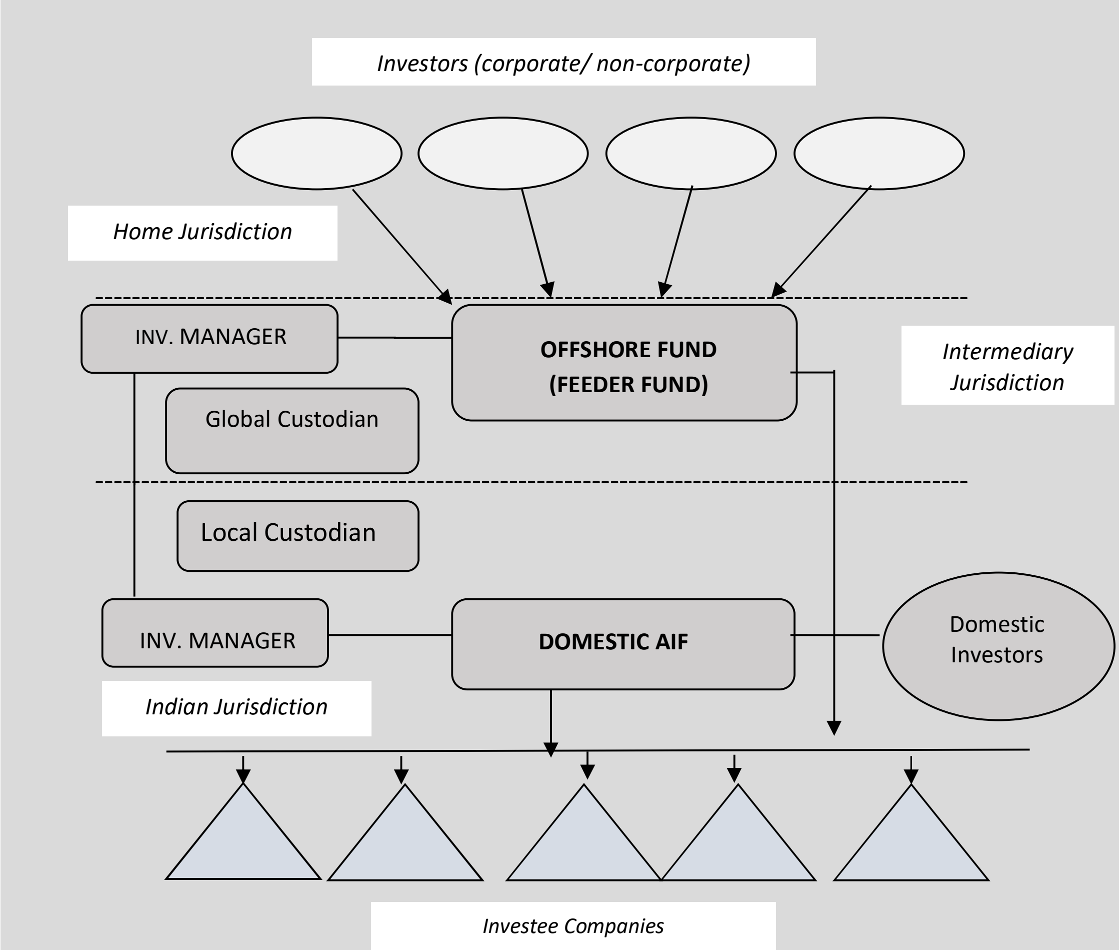


Under this structure (depicted above), the fund is incorporated outside India by choosing an appropriate jurisdiction and subject to local laws of constitution in that country. The investment management also is typically conducted from outside India. The custodian is appointed for safekeeping of securities of the corpus of the fund. Only an investment advisor is appointed locally with a representative office and minimal establishment to source deals and liaise with investee companies. Since the fund is incorporated outside India, it requires registration and compliance with the SEBI (FVCI) Regulations. Alternatively, its investments can also be made directly subject to FDI policy requirements without being registered with SEBI. The FDI route is subject to policy restrictions such as sectoral caps and pricing regulations. However, under both these routes, offshore Funds can be optimised for tax and investment purposes using intermediary jurisdictions that have a good tax treaty (Double Taxation Avoidance Agreement) with India and /or a BIPA (Bilateral Investment Promotion and Protection Agreement). As already explained earlier, BIPA protects against repatriation and arbitration risks for foreign investments. For example, the fund can be set up in Singapore or Mauritius which can act as an intermediary jurisdiction.

5.5.3 Parallel Structure of AIF

This structure would apply when Indian and offshore investors co-invest in parallel through a common fund establishment. This is depicted below in Figure 5.3.

Figure 5.3 – Parallel AIF Structure



In the above structure, a combination of a pure domestic structure and a pure offshore structure is adopted. A domestic AIF is set up and registered with SEBI. In parallel, a feeder fund is set up in an appropriate offshore jurisdiction. The offshore feeder fund invests directly to the investee company under the FVCI or the FDI route. Similarly, the offshore investors may invest individually or through the offshore feeder fund. In this structure, the two pools (offshore feeder fund and domestic AIF) are kept distinct. The offshore fund and the domestic AIF have separate management structures. The domestic AIF is managed by an India based investment manager which may provide recommendations to the investment manager of the offshore fund. However, the parallel structure has several tax and compliance risks.
The concept of Feeder Fund is described in Box 5.1.

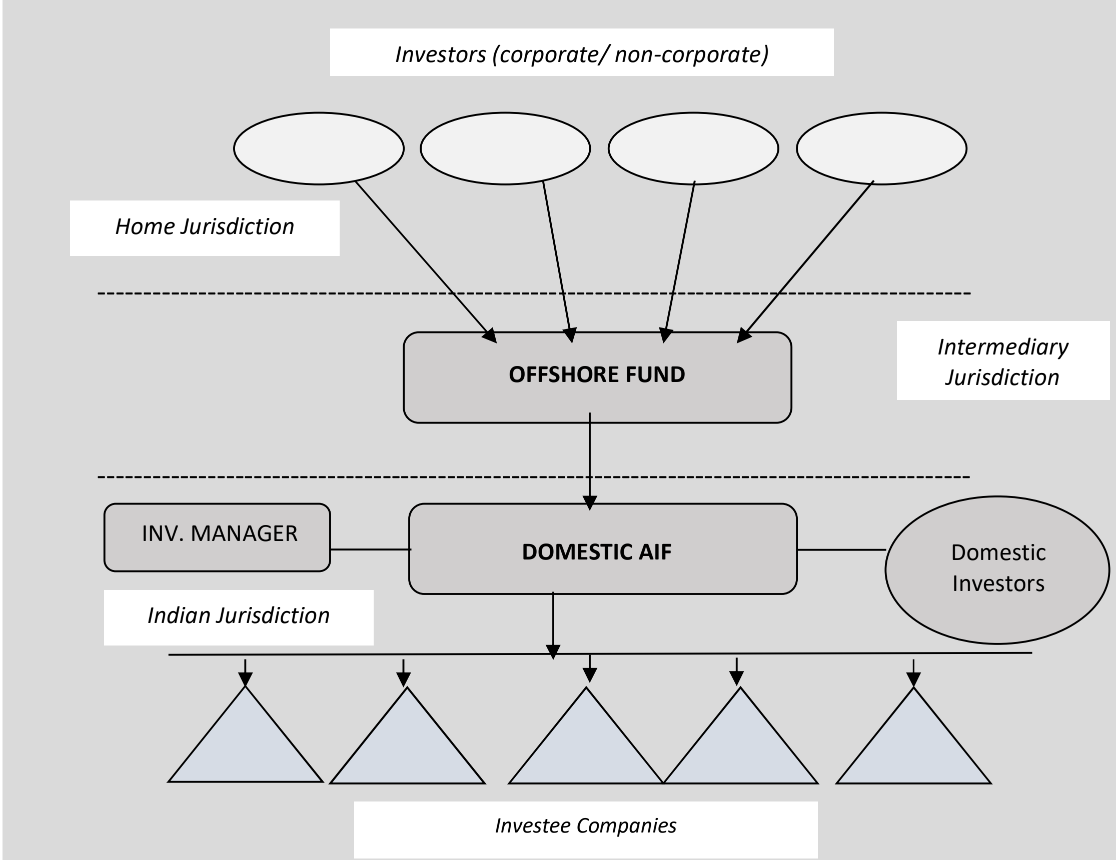
Box 5.1: Feeder Fund

The concept of a feeder fund is to pooling of the offshore contributions from foreign investors in a separate constitution. (known as 'feeder fund') It enables lighter tax compliance in India at feeder fund level rather than individual offshore investor level. If individual investors were to directly invest in a domestic AIF it would increase compliance requirements in India for the AIF since it has to meet individual KYC requirements for each investor. In contrast, if a feeder fund is created, the pooling happens in a foreign jurisdiction and the domestic AIF in India will have all the contributions coming in as that of the feeder fund. However, formation of a feeder fund abroad is not a mandatory requirement if it is not suitable in a particular situation.

5.5.4 Unified Structure of AIF

This alternative is the same as the parallel structure except that the offshore feeder fund would not make any direct investments in the investee companies. Instead, the entire feeder fund capital is invested into the domestic AIF, which is registered with SEBI. In addition, a unified structure allows aggregation of the pool from both the off-shore and the domestic corpuses into a single fund (domestic AIF). A larger corpus at the Indian AIF level will help tap larger and better deals by the investment manager. Unified structure, therefore, provides an alternative route to the offshore investors. The unified structure is depicted below in Figure 5.4.

Figure 5.4 – Unified AIF Structure



5.5.5 Comparative Analysis

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

Table 5.1: Comparative Analysis

Feature	Pure Domestic	Pure Offshore	Parallel	Unified
Pooling Vehicle	In India	Foreign jurisdiction	Both in India and abroad	Both in India and abroad (including GIFT city in India)
No. Of Pooling Vehicles	1	1	2	2

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

Sample Questions: Chapter 5

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

a. Company
b. Partnership
c. Trust
d. NBFC

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

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

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

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

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

a. True
b. False

5. In a parallel structure, there are two funds registered under the SEBI (AIF) Regulations 2012. State whether True or False.

a. True
b. False

CHAPTER 6: RISK AND RETURN – FUND AND INVESTOR PERSPECTIVE

LEARNING OBJECTIVES:

After studying this chapter, you should know about:

- Basics of risk and return
- Nature of Equity and debt investments
- Nature of risks in AIFs (Investor level and Fund level)
- Various return metrics in AIFs (FIRR/ MIRR/ PIC Multiple/ DPI/ RVPI/ TVPI/ AIF alpha etc.)
- Concept and importance of J curve

6.1 Basics of Risk and Return

Financial investments are fraught with risk but the nature and quantum of risk depends, among a host of other factors on the type of instrument, i.e. equity, debt or preference capital. To calculate returns from such investments there are basically two approaches – (1) metrics that calculate absolute returns and (2) metrics that use the present value of money by discounting future cash flow from the investments at an appropriate risk adjusted rate. While the former approach requires comparison with the opportunity cost[87] on annualised basis, the latter approach does the same on a discounted basis.[88]

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[87] 'Opportunity cost' is a term used to denote the benefit foregone in a different alternative for making a particular choice. For e.g. if a person invests a sum of money in a bond providing an interest of 10% p.a. instead of putting the money in a fixed deposit earning an interest of 7%, it makes better sense since the bond yields more than its opportunity cost. The additional return has to be weighed against the additional risk if any from the bond to arrive at the proper investment decision. Opportunity cost is therefore a useful tool in investment analysis.

[88] Discounting of a future sum of money to arrive at its Present Value is based on the concept that money is worth more today than it will be tomorrow due to inflation. This concept is known as the 'Time value of money'. This concept is fundamental and forms the core of most financial computations.

Suppose someone promises to give INR 1,000 three years hence. What is the present value of this amount if the interest rate is 10 percent? The present value can be calculated by discounting INR 1,000 to the present point of time, as follows:

Value three years hence = INR 1,000

Value two years hence = INR 1,000 x (1/1.10) = INR 909

Value one year hence = INR 1,000 x (1/1.10) x (1/1.10) = INR 826

Value now (present value) = INR 1,000 x (1/1.10) x (1/1.10) x (1/1.10) = INR 751

Present Value is therefore arrived at by multiplying the future sum with a present value factor for the required number of years. The present value factor is indicated in brackets above. The use of present value concept in financial analysis is discussed in Chapter 11.

Illustration 6.1

If an investment of INR 10,000 is returned after 3 years as INR 19,000, the average returns are INR 3,000 per annum which yields an average annualised return of 30% on the original investment. However, this approach does not consider the timing of the cash flow. If the discounted value of the cash flow is considered, it is possible to compute the rate at which it would be equal to the original investment (therefore proving the returns). This metric is known as the 'internal rate of return' (IRR) which when used in the context of financial returns by the private sector is known as the financial IRR or the FIRR. In the given example, it would work out to 24%. In investment parlance, IRR on an investment is also known as the 'money weighted return'.

In an AIF context, initial contributions go towards the corpus and the returns provided for by the fund are called 'realisations', and the ultimate profitability of a fund is driven by the number and size of these realisations. The understanding of investor risks and the difficulty in computation of returns from realisations is extremely important both from an investor and distributor perspective.

6.2 Nature and Types of Debt Investments

Debt investments by AIFs could consist of loan financings to investee companies, unlisted debt securities like non-convertible debentures, listed or to-be-listed debentures and other forms of structured financing such as sub-ordinate debt and mezzanine financing. Some of the debt may also be towards working capital financing of the investee / borrower company. Real estate, infrastructure and special situation funds could also provide financing against project or control interest[89] in a special purpose vehicle (SPV) or against security receipts/ REIT units/ InvITs (these are known as 'securitised debt instruments') issued by a securitisation trust or company. These financings may be secured or unsecured against the tangible assets of the company, project rights, intangible assets, bank guarantees for domestic debt, cash or securities escrow or pledge, or trust and retention account or against collaterals such as shares and personal assets of shareholders. Debt investments have inherent credit risk since they are based on an assessment of the borrower's servicing capacity through future cash flow generation in business. Though debt securities may be secured as mentioned above, in many situations, the recovery value of such debt protections are sub-optimal. Furthermore, when the borrower is in a debt trap or distress, the carrying cost of such debt for the investor may be extremely high leading to further loss in value. In

[89]'Control interest' or 'controlling interest' or 'control rights' refers to shareholding or voting rights in a company that provide management control. The minimum such rights are 51% which provide simple majority control. Sometimes, such rights may also be accorded through a specific contract instead of voting rights.

most cases, debt resolutions pose difficulty and delays including litigation and court mandated process.

Keeping in view the claims that debt holders may have on the borrower's assets and cash flow, debt can be tranched into categories. 'Senior or secured debt' is the name given to the debt that has priority over all other debt when it comes to receiving interest, or to receiving the proceeds from asset sales in insolvency. Senior debt has first charge on such claims. This seniority gives lenders the ability to negotiate better or expect better outcome in a resolution or liquidation process. 'Sub-ordinated debt' or 'Junior debt' ranks after the senior debt with claims ranging from second charges to residual charges (see Table 6.1). In order to understand the risk perception of debt, the debt issuances by companies are usually rated by an external credit rating agency. However, in AIF domain, many debt investments may be unrated and illiquid without a secondary market.

AIFs also invest in mezzanine capital financings. Mezzanine finance comes in many forms. Venture capital funds finance a significant amount of debt to early stage companies (known as 'venture debt') which takes the form of mezzanine financing. The common features of all mezzanine instruments and products are that they offer a risk/return profile that lies above that of debt and below that of equity. Mezzanine is used to finance a company where the banks have no appetite to lend further senior debt but there is still more capacity for introducing long-term unsecured borrowings. Such a situation may arise when the security provided by the assets of the company is fully utilised to support the senior debt package, but the cash flows will support further borrowings. An AIF will therefore wish to receive a higher yield on the instrument that has no underlying asset security. Another situation could be when there are large forecast of cash flows contingent on the unlocking of value from a new project or business plan or corporate restructuring and Leveraged Buyouts or LBOs. In such a situation, the mezzanine financier may take the view to lend against these future lumpy cash flows, but require an adequate return to reflect the additional risk. This is often achieved by attaching warrants (options) to the mezzanine debt or by providing some conversion option into equity which would enable the mezzanine fund to share in the equity value of the business at exit.

Table 6.1 –Primer on Priority of Debt Claims

Secured Debt – Defined as a borrowing that are protected by a specific charge on assets or cash flow or contractual rights of the borrower. Assets can be fixed or current or intangible or all or in any combination thereof. All claims provided to lenders are commonly known as 'security' which can therefore mean a variety of claims arising from various charges created in favour of lenders. This process is legally protected through a process called 'security creation'.

Another word used in this context is 'lien'. Lien is a legal right of the lender over the borrower's assets till such time the debt is not repaid in full. Unlike security creation which requires a process of documentation, lien can be created even by law. For e.g. a banker has lien over a depositor's money kept in the bank by law. If not expressly covered by law in a given case, a lien is created when the security creation process is complete. A general lien ranks lower than a specific charge. Secured debt will be ranked on the basis of the charge created – for e.g. debts with first and paramount charge will rank senior-most. They are followed by secured debt with second charge and so on. When there are multiple lenders requiring the same level of charge, a common charge is created on the same pool of securities. This is known as '*pari passu* charge'. If two secured borrowings are charged on the same asset(s) with the same level of charge, the one that has been registered first becomes senior to the other. Charges created for secured debt can be 'fixed or floating'. Fixed charges need to be enforced against specific assets while floating charge extends to the entire group of assets under charge. Floating charge does not take effect until it is crystallised by a due process. In the event of crystallisation, if there are existing fixed charges on the same assets, they take priority over floating charge.
Sub-Ordinate Debt – All borrowings that rank less than secured debt with first charge are called sub-ordinate debt. Therefore, sub-ordinated debt can be with second or any subsequent charge.
Unsecured debt – A borrowing that is not secured by any fixed or floating charge or a lien is an unsecured debt. It ranks lowest in enforceability in the list of debt obligations of the borrower.
Priority of Claims – 1. Secured Senior debt has the first and highest claim on the borrower but the priority of claims within all secured debts is enforced on the basis of the seniority of charge created. 2. Secured Sub-ordinated debt ranks next but the priority of claims is again decided on the basis of seniority of the charge within the overall category. 3. Unsecured debt ranks lowest among all debt. It is paid out only after claims of all secured debt is satisfied in full.
Note: All debt claims irrespective of whether they are secured or not have priority over preference capital which ranks higher than equity capital. Equity only has residual claim on the company after preference shareholders' claims are fully satisfied.

6.3 Nature of Equity Investments

While debt investments are about credit risk and adequacy of cash flow, equity investments are positioned to benefit from the upside of growth and valuation of the investee company. Accordingly, the earlier the investment in a growth oriented company, the better are the equity returns, albeit with higher risk. A lot also depends upon the entry valuation for the investor in the company. The higher the entry price, the lower would be the returns. Equity investments may also generate periodic returns in the form of dividend distributions in cash or in stock (known as bonus shares). Equity investments may also entail follow-on funding to provide continuous growth capital to the company which are known as Series A, B and C in VC/PE industry terminology. Category I AIFs are ideally positioned to take early stage risks in equity investments (typically series A) while Category II AIFs are about later stage investments (typically series B and C) wherein the ticket size of financings are larger but the risk is moderated with comparatively lower returns.

Equity investments may also be positioned for taking controlling positions in investee companies. Sometimes AIFs co-invest in control acquisitions or finance acquirers of other companies with debt or mezzanine capital. Such transactions are known as 'buyouts' and if leverage is used, they are known as Leveraged Buy-Outs (LBOs).

Some part of AIF investments could also be deployed in listed equities which provide liquidity and growth. However, these are subject to market risks on an on-going basis. Unlisted stocks are the primary domain of Category I and II AIFs which entail apart from normal equity risks, illiquidity risk for investors. In financial parlance, investment risks in listed markets are known as 'systematic risk' while investing risk in alternative assets which have higher risk concentration is known as 'unsystematic risk'. Category I and Category II funds are about primarily taking unsystematic risk in financial investments. Therefore, their return expectations are higher than those investors taking systematic risks.

6.4 Nature of Investor Risks in AIF

When an AIF issues a PPM to investors seeking capital commitments, there are different types of risks associated with such investments. All risks can be either at the investor level or at the fund level. As discussed in the preceding paragraph, investor level risks are prevalent both for equity and pure debt funds. At the fund level as well, there are risks that could mainly relate to external factors, governance, government policy, regulatory and tax framework. While the types of risks that are inherent therein are listed in detail in the Annexure 6.1 to this Chapter, a brief description of each type of risk is provided in Section 6.4.1. The fundamental factors creating risk environment for AIF investors are discussed below.

1. **Risk of Adverse Selection –** Choosing the right fund manager is a difficult task for investors. Fund PPMs sometimes make forward looking statements or show a manager track record that may not be an assurance of future performance. The risk of adverse selection of a manager would mean either sub-optimal returns or moral hazards for investors.
2. **Illiquidity and Uncertainty –** Under the AIF Regulations, Category I and II AIFs need to be close ended funds because such investments are primarily illiquid. Illiquidity refers to the inability of the fund to sell its investments reasonably at proper exit valuations within the life cycle of the fund. In the case of AIF investments, illiquidity can be especially severe when a fund has remaining capital calls or when an investor attempts to liquidate a position before its termination. Secondary market (discussed in a subsequent Chapter) for AIFs is not well-developed in India due to which investors may not be able to exit the fund till winding up and distributions are completed in full. In times of market stress, the fund would also find it difficult to make exits from its investment at optimal value. Similarly, when fund cycle does not permit extensions, exits may be ill-timed or under-valued.
3. **Fund Monitoring** - Monitoring AIF progress and performance during its life may provide relatively diminished benefits because an investor's options in Category I and II funds are more limited than in the case of Category III funds. There is also limited control over managers in an AIF. Lack of proper investment opportunities may sometimes curtail fund performance. Nevertheless, monitoring is advisable and investors can play valuable roles in working with fund managers. As the fund managers are likely to launch a new scheme or fund in future, this monitoring activity can be quite valuable.
4. **Cash Management** - Uncertain capital calls and uncertain exits (with regard to both size and timing) raise substantial cash management issues for AIF investors. Because it is unclear when the committed capital will be called and how much cash will be generated in the interim in the form of distributions from previous investments, it is difficult for an investor to predict and control the cash flow. An institutional investor that sets aside large amounts of cash to meet potential calls runs the risk of diluting performance by compromising returns due to idle cash. Institutional investors often pursue an over-commitment strategy in which forecasted capital calls on outstanding commitments exceed current cash balances.
5. **Underlying Investment Risks –** Like in any investment activity, when an AIF invests its capital in underlying investee companies, it takes a variety of investment risks as well as business risks of investee companies. These could relate to a variety of areas such as policy and regulatory risks, state of economy, financial markets, interest rates, foreign exchange risks for offshore investors, reliance on service providers, industry risks of a sector, governance risks in investee companies, litigation, tax law inconsistency etc. In Category I funds, investments are made early due to which, they could be the risk of adverse selection, infant mortality and lack of step-up in value.

Category II funds may make some investments in listed equity and debt which are subject to capital market risks. The fund makes its returns based on appreciation in the value of underlying investee companies which can be affected by any of the above risks.

6. **Debt Financing Related Risks –** Many Category I and II investments could be in debt securities and financings include pure debt funds and special situation funds that address stressed company financings, LBOs among others. Debt financing is subject to credit risk which would consist mainly of interest rate risk and default risk. Some debt funds are sectoral funds for assets in real estate and infrastructure sectors which could have long gestation and other project risks along with cash flow problems. There could be risk in recovery of interest as well as capital in such investments arising from default, illiquidity and debt resolution process.

6.4.1 Fund Level Risks

Based on the inherent factors due to which risk arises in AIF investments as discussed above, the fund level risks that investors need to bear in mind are briefly listed below. These are a part of the risk factors that investors assume which are distinct from the underlying risks faced by investee companies that are automatically subsumed by the fund due to its exposure to them. The Fund level risks are broadly categorised as follows –

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

foreign AIF investors when they repatriate the proceeds in foreign currency. Similarly, a slowdown in the general economy could impact businesses of underlying investee companies. This may have an adverse effect on fund valuations and exits that would in turn adversely affect investor returns.

6.5 Primary Metrics of Returns

The first step in understanding the return perspective would be to know the difference between simple rate of return (simple interest or 'coupon rate') as compared to the 'yield' (compound interest or FIRR) of an investment. In financial analysis, the internal rate of return (IRR) is a very strong metric and can be used in multiple contexts to provide useful conclusions since it finds the discounting rate that is inherent in an investment by equating the future positive cash flows to the present value of such investment. The IRR used in an investment context is just called the IRR or 'yield' or more specifically the Financial Internal Rate of Return or the FIRR. For e.g. if a Non-convertible debenture is issued with a face value of INR 100 at 10% yield, it means that the debenture would be entitled to a simple interest of 10% per year on INR 100, i.e. INR 10/-. The coupon rate on debt instruments is fixed based on the credit rating of the issuer, interest rates in the economy and prevailing market rates of corporate debt. However, depending on the periodicity and timing of the payment of such interest, the 'yield' or the IRR could be different.

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

Illustration 6.2

In the example given below, an investment of INR 100 and a coupon rate of 15% have been considered for computation of yield with different streams of cash flow. The tenor of the bond is one calendar year and the principal is repaid at the end of the twelfth month. However, the interest payments are varied in each case because of which the yields vary. In the first case, the interest flows are at the end of the year and therefore, the yield is same as the coupon rate. In the second case, the interest flows are half-yearly because of which the yield improves to 15.56%. If the interest payments are made quarterly, the yield improves further to 15.87% and on a monthly interest payment schedule, it goes up further to 16.08%. Therefore, the faster the cash flows come back to the investor, the higher is the yield on the instrument. This is of course, under the assumption that the investor is in a position to reinvest the cash flows in other investment opportunities providing the same yield. The detailed computations drawn through an excel sheet are shown in Table 6.2:

Table 6.2: Computation of Yields

Bond Face Value	**100**			
Coupon rate	15%			
Time periods	**Annual**	**Bi-annual**	**Quarterly**	**Monthly**
Y0	-100			
Y1	115			
Y0		-100		
HY1		7.5		
HY2		107.5		
Y0			-100	
Q1			3.75	
Q2			3.75	
Q3			3.75	
Q4			103.75	
Y0				-100
M1				1.25
M2				1.25
M3				1.25
M4				1.25
M5				1.25
M6				1.25
M7				1.25

M8				1.25
M9				1.25
M10				1.25
M11				1.25
M12				101.25
Basic Yield	**15.00%**	**7.50%**	**3.75%**	**1.25%**
Annualised Yield	**15.00%**	**15.56%**	**15.87%**	**16.08%**

Yo denotes the time of investment.

HY denotes half-year.

Q denotes a quarter of three months.

M denotes a calendar month.

Working with the formula on effective rate,

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

Where r is the effective rate of interest, k is the nominal rate of interest, and m is the frequency of compounding per year, the yields shown above may also be computed using the formula.

Basic yield for annual payment = 15%

Effective Yield = $(1+0.15/1)^1 - 1 = 1.15 - 1 = 0.15 = 15\%$

Basic yield for annual payment = 7.5% for half year, i.e.15% p.a.

Effective Yield = $(1+0.15/2)^2 - 1 = (1.075)^2 - 1 = 0.1556 = 15.56\%$

Basic yield for annual payment = 3.75% for a quarter, i.e.15% p.a.

Effective Yield = $(1+0.15/4)^4 - 1 = (1.0375)^4 - 1 = 0.1587 = 15.87\%$

Basic yield for annual payment = 1.25% for a month, i.e.15% p.a.

Effective Yield = $(1+0.15/12)^{12} - 1 = 1.1608 - 1 = 0.1608 = 16.08\%$

6.5.1 Yield to Maturity (YTM)

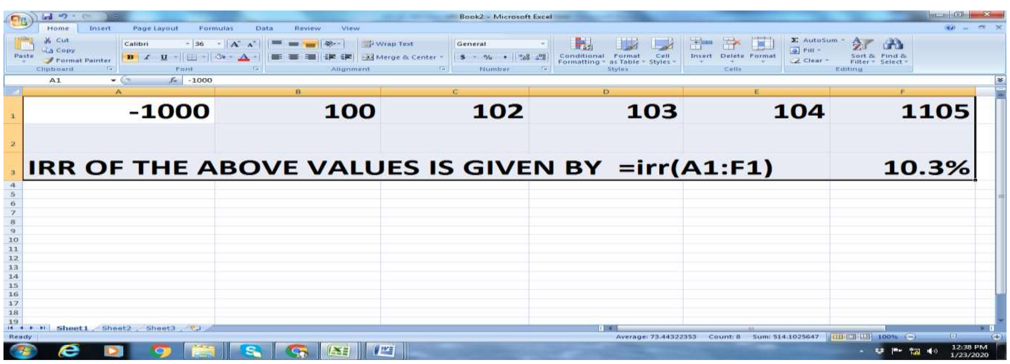
The YTM is the FIRR of an investment from the beginning of the instrument till the date of maturity. This is typically used in fixed tenor debt instruments. Similarly, the FIRR of an equity investment would be the FIRR returned on the investment from the date of investment till the date of exit. In computing the FIRR, the interest or dividend distributions are also taken into account.

Mathematically, the YTM is the FIRR that makes the present value of the cash flows receivable from an investment equal to the present value of the initial investment. It can be depicted by the following equation:

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

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

Using an 'IRR' function in a Microsoft excel spreadsheet would require defining the range within brackets prefixed with =IRR. Shown in the screen shot below:



6.6 Return Measurement Metrics in Alternative Investments

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

6.6.1 The FIRR

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

In AIF context, there could be a differential between Gross and Net IRR of an investor, the reasons for which are detailed further in Section 6.6.6. of this Chapter. This aspect is of particular significance for distributors. The worked out example provided in Section 6.8 also illustrates that there would be a difference in the Gross and Net FIRR and distributors need to educate investors about the reasons for such differential.

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

Illustration 6.3: IRR

Date	Y0	Y1	Y2	Y3	Y4	Y5	Y6	Y7
Capital Calls	-20	-30						
Distribution			0	0	20	30	40	50
Total	**-20**	**-30**	**0**	**0**	**20**	**30**	**40**	**50**
FIRR	**22%**							

6.6.2 The MIRR

In investment analysis, it is sometimes beneficial to use the Modified Internal Rate of Return or the MIRR which is an improvement over the IRR. Essentially, the IRR uses the same rate of discounting (or compounding depending upon how you look at it) to arrive at the computation of the implicit rate of return. However, this does not fit in real life situation. In the example given above, the IRR is 22% which may not be the cost of capital of an investor or the opportunity cost of other investments in the market. Therefore, the MIRR considers the opportunity cost of funds at the appropriate rate and computes the return which would then be more realistic.

In the previous example, if we were to consider the opportunity cost at 10% both for capital calls and distributions, we can discount the capital calls at 10% to Y0 and compound the distributions at 10% to Y7. The resultant IRR of the distribution is known as the MIRR as shown below.

Date	Y0	Y1	Y2	Y3	Y4	Y5	Y6	Y7
Capital Calls	-20	-30						
Distribution			0	0	20	30	40	50
Total	-20	-30	0	0	20	30	40	50
Factor at 10%	1.00	0.91			1.33	1.21	1.1	1.0
Discounted / Compounded Values	-20 -27.3							50 44 36.3 26.6
Total	**-47.3**							**156.9**
MIRR	**18.7%**							

It may be observed from the above computation that the MIRR provides a more realistic measure than the FIRR to evaluate the returns from an investment.

6.6.3 PIC Multiple

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

6.6.4 The DPI

Distributed to Paid in Capital **(DPI) -** This can also be called the realisation multiple. It measures the amount that has been paid out to investors. It is calculated by dividing cumulative distributions to investors divided by paid in capital. This multiple tells the investors how much money they got back. This is better for evaluating a fund later in its life because there are more distributions to measure against. For example, if the total distributions to date cumulate to INR 400 crore, on the total PIC of INR 1000 crore, the DPI at fund level amounts to 0.40 or 40%.

6.6.5 The RVPI

Residual Value to Paid in Capital **(RVPI) -** Early in a fund, RVPI or the unrealised multiple is more representative of future returns than DPI. The RVPI measures the remaining market value of the fund's capital which has not yet been realised. It is calculated by dividing the residual value (or fair market value) of underlying investments by the PIC. Investors need to keep in mind that the residual value is an estimate and is not always accurate depending upon the valuation methodology used for unrealised assets. For example, if the residual value has been estimated at INR 1100 crore, the RVPI would amount to 1.10 for a capital of INR 1000 crore.

6.6.6 The TVPI

Total Value to PIC **(TVPI)** also known as Multiple on Invested Capital **(MOIC)** is the fund's investment multiple and the fundamental metric in measuring private fund performance. Simple to understand and use, it measures the total value created by a fund. It can be calculated in two ways: (1) By dividing cumulative distributions + residual value of unsold investments by the PIC. (2) It can also be found by adding together the DPI and RVPI. This multiple is what is commonly referred to as '**Net Multiple'**. Since the RVPI is incorporated, the TVPI will fluctuate until the fund is fully realised. In the given example above, the TVPI would amount to 1.50 which is also the aggregate value of the DPI and the RVPI.

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

$$TVPI = [\frac{(Cumulative\ Distributions + Valuation\ of\ unrealised\ assets)}{PIC} - 1]\ x\ 100$$

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

$$DPI = [\frac{Cumulative\ Net\ Distributions\ to\ Investor}{PIC\ of\ the\ Investor} - 1]\ x\ 100$$

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

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

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

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

6.6.7 The Kaplan-Schoar Public Market Equivalent (KS-PME)[90]

This method satisfies the requirements of adopting a benchmark to the listed markets in measuring the performance of an AIF. It measures the relative efficiency of the AIF investment vis-a-vis index returns from the market. It measures the returns from the index between the relevant dates of the AIF measurement, i.e. the date of capital calls, distributions and the valuation date. By adopting the market rate of return as the compounding factor, it compounds the capital calls and distributions to the valuation date. It then calculates the TVPI of the resultant figures. If the market adjusted TVPI is greater than 1, it means the AIF outperformed the market and vice versa. Therefore, this method is nothing but the measurement of market adjusted TVPI. It is represented as:

KS-PME = (Sum of future value distributions + NAV) / Sum of future value capital calls

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

Illustration 6.4

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

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

6.6.8 Direct Alpha[91]

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

Illustration 6.5

Date (1)	Capital Call (CC) (2)	Distribution(D) (3)	NAV (4)	Net Cash Flow (5)=(2)+(3)+(4)	Market returns (5)	FV (CC) (6)	FV (D) (7)	FV (NAV) (8)	Net FV of Cash Flow (9)=(6)+(7)+(8)
Y0	-20	-	-	-20	18%	-44.55*			-44.55
Y1	-30	-	-	-30	14%	-56.63#			-56.63

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

Y2	-	-	-	0	16%	-	-	-	0
Y3	-	-	-	0	22%	-	-	-	0
Y4	-	20	120	140	17%	-	20	120	140
	Fund IRR[$]			**35%**		**Direct Alpha[$]**			**10%**

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

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

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

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

Thus the below table summarizes the metrics so discussed earlier as:[92]

	Rate of Return	**Total Return**
Absolute Return	IRR (or FIRR) MIRR	TVPI
Market-adjusted Return	Direct Alpha	KS-PME

6.6.9 Gross Vs Net Metrics (pre fee and post fee)

Managers often use gross and net FIRR and ROI multiples interchangeably in marketing and reporting literature; so discerning investors should clarify which figures are actually being represented. Gross metrics represent the fund's gross returns and do not account for management fees, other fees and expenses and additional returns. Sometimes, the opportunity cost of cash management by the investor is also factored in during the investment cycle when there is still dry powder left in the fund system. Net metrics are more representative of the actual returns an investor would have received because they include the effects of fees, carry. Net metrics can be calculated either pre-tax or post-tax. Net multiples also vary between investors due to factors such as preferential rights, discounts etc. In offshore investing in domestic AIFs, the exchange risks and withholding taxes impact a specific investor's net returns.

An important figure to evaluate in a firm's performance history is the gap between gross and net FIRR or the ROI multiples. It is generally larger earlier in a fund's life due to the effects of fees but it should narrow down as the fund life increases. Once the entire capital is invested and returns start to kick in, it could narrow down since more capital is at work and the

[92]https://www.insead.edu/sites/default/files/assets/dept/centres/gpei/docs/Measuring_PE_Fund-Performance-2019.pdf

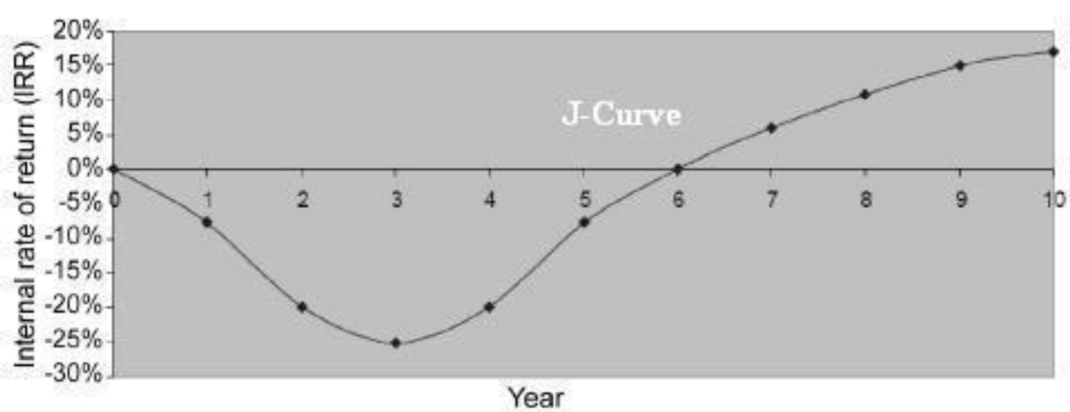
returns keep increasing to reduce the differential. A large spread between the gross and net multiple can mean the manager is not managing the fund efficiently.

Prospective and existing investors in alternatives must look at a combination of the FIRR and the multiples approach to get a more realistic view of fund performance. Viewed together, they can get a strong indication of fund performance for a fund that can measure against customised peer benchmarks and public markets indices as well.

6.7 The J Curve

At this time, it is relevant to understand the pattern of return behaviour in AIFs based on the life cycle of the fund. There would be a significant difference between fund performance metrics in the vintage[93] years of the fund cycle vis-a-vis its maturity years. The cash flows of the fund are initially negative during its investment period as investments are still being made due to the effect of fees and expenses on the returns. Returns start to improve and will become positive once the investments start to generate yield and are realised. This, coupled with the fees noted above, results in the cash flow profile known as the 'J curve'. The difference between the Gross IRR and the cumulative cash flow will, in all probability, be exaggerated as the total return statement should include the value of unrealised investments. As the fund reaches its maturity years, the gap reduces and by the close of the fund the cumulative cash flows equal the cumulative total return. The J curve is represented in the diagrams shown below.

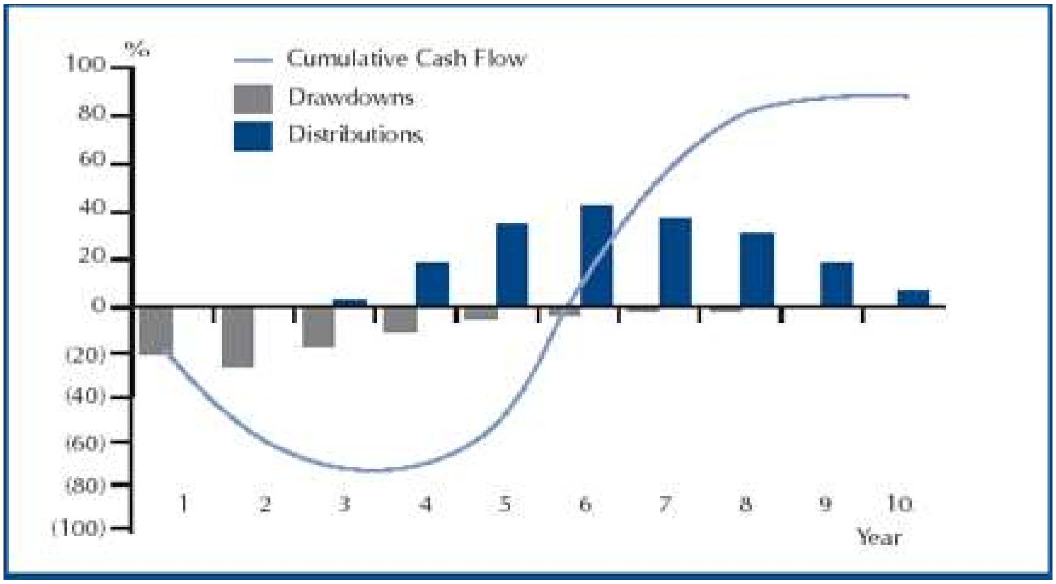
Figure 6.1 – FIRR Behaviour over Fund Life Cycle – J Curve[94]



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

[94]Source: investment-and-finance.net

Figure 6.2 – Cash Flow Behaviour over Fund Life Cycle – J Curve[95]



It may be observed from Figure 6.1 and Figure 6.2 that the IRR behaviour is based on the cash flow generated by the fund. In the initial years, cash flow is negative as the fund is drawing down committed capital and investing. The underlying investments would not have significant value at that stage as the process has just begun. Exits are not envisaged during those years and so the fund does not get back any return of cash invested. Therefore, distributions are insignificant in those years. Though the fund calculates the IRR based on underlying value of the investments, the fund value would still be in the negative, thereby yielding negative IRRs.

In subsequent years (year 4 onwards), the value accretion in investee companies is encashed through exits and distributions due to which the positive cash flow has peaked in year 6. The distributions continue till year 10 and cash flow remains positive. This is reflected in increasing IRRs which reach the peak in as the fund enters its maturity years in year 8. In the given figure, since most of the distributions are completed by year 8, the IRR does not grow in year 9 and 10 but remains stable at the peak.

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

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[95]Source: venturechoice.com

6.8 Worked out Case[96]

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

In order to appreciate the various technical descriptions and workings given in this worked out example, readers are advised to familiarise the concepts of Management Fees and Expenses (Section 3.7) that are borne at fund level and at investment management level, preferred return and additional returns (Section 3.8), distribution waterfall and catch up (Section 3.9) and clawback (Section 3.9.1) from the discussions provided in Chapter 3.

Let us consider the following information.

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

The other assumptions required for computations are provided below:

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

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

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

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

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

Step 1- Cash Flow

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

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

The paid in Capital is INR 2000 crore including the green shoe option which is assumed to have been achieved by beginning of Y1. In other words, the investment manager has been able to make the required investments by drawing the committed capital in full and completing fund investments by the end of the investment period except to provide for fees and expenses for Y2 and Y3 (i.e. INR 30*2*2 = INR 120). Accordingly, the drawdown is INR 700 crore at the beginning of Y0 and INR 1300 crore at the beginning of Y1 (fully utilised in Y0 and Y1). [Fund Investments (Outflow) = 700+1300-20-20-(30*4) = INR 1840; where (30*4) represents the management fees and expenses for Y2 and Y3 respectively]

Management fees and expenses are computed as per the given data. All other items such as GST etc. have been ignored and the entire corpus is utilised to meet the fund investments and fees and expenses in Y1, Y2 and Y3. Thereafter, the cash inflow from realisations year on year has been calculated as the sum of the distributions and the fees and expenses.

Step 2 – Gross FIRR (Fund Level)[97]

Now that we have the cash flow over the fund life cycle, we are in a position to compute the first metric, the FIRR achieved by the fund. Since the FIRR can be on gross or net basis, let us first consider the Gross FIRR, i.e. excluding the fees and expenses. The workings are provided below. The Gross FIRR has been computed by using 'IRR' function in excel.

	Y0	Y1	Y2	Y3	Y4	Y5	Y6	Y7	Y8
Invested Capital from Investors	-700	-1300	0	0	0	0	0	0	0
Cash Inflow from realisations	0	0	0	0	100	500	800	1000	6900
Value of Unrealised Investments		500	1240	1200	1300	1500	1900	3000	0
Cumulative Value (Incl distributions)	**0**	**500**	**1240**	**1200**	**1400**	**2100**	**3300**	**5400**	**9300**
Gross Cash Flow for FIRR over Fund Cycle	**-700**	**-1300**	**0**	**0**	**100**	**500**	**800**	**1000**	**6900**
Gross FIRR over Fund Cycle **25.45%**									

Step 3 – Gross FIRR YoY

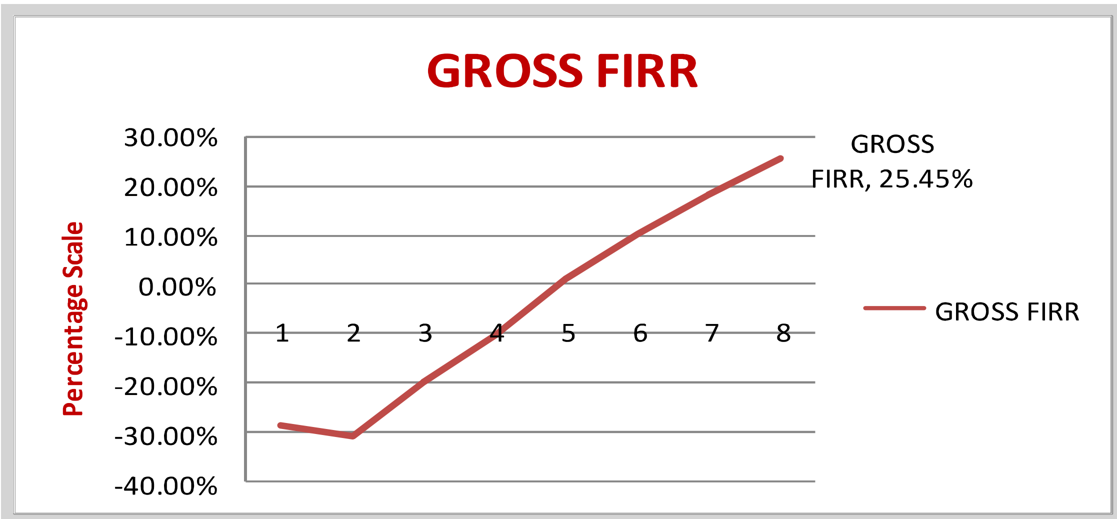
The Gross FIRR provided above is over the entire fund life cycle. Since the data is available, it can also be computed Year on Year (YoY) to understand the distribution of the returns as shown below.

YoY Gross FIRR		Y0	Y1	Y2	Y3	Y4	Y5	Y6	Y7	Y8
Y1	**-28.57%**	-700	500	0	0	0	0	0	0	0
Y2	**-30.57%**	-700	-1300	1240	0	0	0	0	0	0
Y3	**-19.72%**	-700	-1300	0	1200	0	0	0	0	0
Y4	**-10.13%**	-700	-1300	0	0	1400	0	0	0	0
Y5	**1.14%**	-700	-1300	0	0	100	2000	0	0	0
Y6	**10.24%**	-700	-1300	0	0	100	500	2700	0	0
Y7	**18.23%**	-700	-1300	0	0	100	500	800	4000	0
Y8	**25.45%**	-700	-1300	0	0	100	500	800	1000	6900

[97]In this Step 2, the following may be noted:
1. The fund start date is considered from the beginning of Y0. Therefore, for reckoning a full year of investment, INR 700 crore is represented in Y0 and INR 1300 crore in Y1 for computation of FIRR. In effect, INR 700 crore is invested for 2 years and INR 1300 crore for 1 year during the investment period.
2. The Cumulative Value is shown only at the invested capital amount during the investment phase and thereafter as the sum of the Cash flow from realisations and the value of unrealised investments. In Y8, the cumulative value will be sum of all cash inflow from realisations.
3. The figures described in 1 and 2 above are for representation purposes only and do not affect the computations. They can be appreciated better from Step 3 where the year-wise FIRR computations are furnished.

Step 4 – The J Curve for the Gross FIRR

As explained in the previous discussions, the returns from AIF are in the form of the J Curve reflecting negative returns in initial years and growing returns towards the maturity years. The graphical representation of the above distribution is provided below.



Step 5 – The Net Cash Flow (Fund Level)

From the Gross Cash Flow computed in Step 2, we can now arrive at the Net Cash Flow over the fund cycle. To do so, we need to calculate fees and expenses over the life cycle. Based on the given data, the fees and expenses have been computed. Accordingly, the net cash flow is arrived at as follows.

	Y0	Y1	Y2	Y3	Y4	Y5	Y6	Y7	Y8
Gross Cash Flow for FIRR over Fund Cycle	**-700**	**-1300**	**0**	**0**	**100**	**500**	**800**	**1000**	**6900**
Fees & Expenses		40	60	60	60	60	60	60	60
Cumulative Fees & Expenses over fund cycle		40	100	160	220	280	340	400	460
Net Cash Flow for FIRR over Fund Cycle	**-700**	**-1300**	**0**	**0**	**40**	**440**	**740**	**940**	**6840**

Step 6 – The Net FIRR

We can now repeat the same steps furnished above in the Computation of the Net FIRR. Over the life cycle of the fund, the Net IRR based on the net cash flow furnished in Step 5 is shown below.

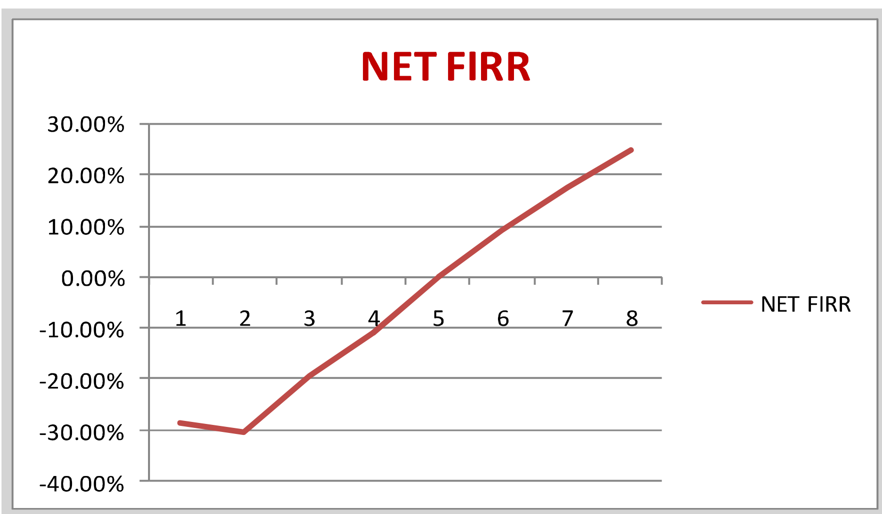
		Y0	Y1	Y2	Y3	Y4	Y5	Y6	Y7	Y8
Net Cash Flow for FIRR over Fund Cycle		-700	-1300	0	0	40	440	740	940	6840
Net FIRR over Fund Cycle	24.56%									

Step 7 – Net FIRR YoY

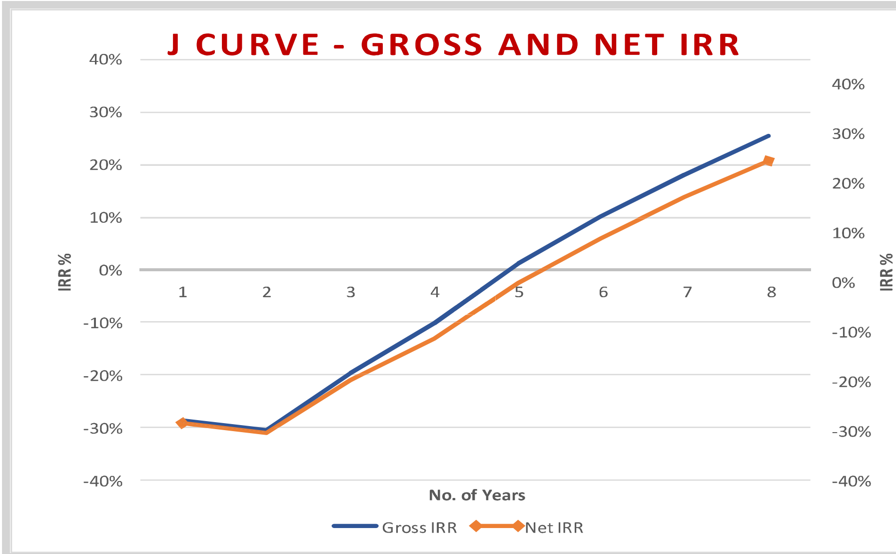
YoY Net FIRR		Y0	Y1	Y2	Y3	Y4	Y5	Y6	Y7	Y8
Y1	-28.57%	-700	500							
Y2	-30.57%	-700	-1300	1240						
Y3	-19.72%	-700	-1300	0	1200					
Y4	-11.31%	-700	-1300	0	0	1340				
Y5	-0.23%	-700	-1300	0	0	40	1940			
Y6	8.95%	-700	-1300	0	0	40	440	2640		
Y7	17.13%	-700	-1300	0	0	40	440	740	3940	
Y8	24.56%	-700	-1300	0	0	40	440	740	940	6840

Step 8 – The J Curve for the Net FIRR

The J curve plotted for the Net IRR would appear as follows.



If we now plot the Gross IRR and Net IRR on the same diagram, they would appear as follows



It may be observed from the above combined representation that there would be a difference in the trajectory of the Gross and Net FIRRs because of the deduction of fees, expenses and other deductibles such as taxes from the gross realisations and unrealised value of investments of the fund from time to time. Distributors need to make investors aware of this important difference, thereby obviating an expectation gap.

Step 9 – Hurdle Rate Distribution

The next step is to arrive at the distribution required to provide the investors their hurdle rate requirement of 10%. This computation is provided below.

Hurdle Rate Computation	Y0	Y1	Y2	Y3	Y4	Y5	Y6	Y7	Y8
Y1	-700	0							
Y2	-700	-1300	0	0	0				
Y3	-700	-1300	0	0	0				
Y4	-700	-1300	0	0	40				
Y5	-700	-1300	0	0	0	440			
Y6	-700	-1300	0	0	0	0	740		
Y7	-700	-1300	0	0	0	0	0	940	
Y8	-700	-1300	0	0	0	0	0	0	1460
Investor Cash Flow	**-700**	**-1300**	**0**	**0**	**40**	**440**	**740**	**940**	**1460**
Investor FIRR									
Y8	**10.00%**								

It may be observed from the above table that the investors would get their hurdle rate return satisfied only after the receipt of Year 8 final distribution since the fund gets wound up at the completion of Y8. The amount to be distributed in Year 8 to achieve the hurdle rate is INR 1460 crore after considering previous distributions.

Step 10 – The Distribution Waterfall

Since we have arrived at the Gross and Net FIRR, the next step is to understand how the distribution waterfall would work out for the given commercial terms between the investors and the manager as provided in the case. In this computation, we need to follow the required priority as per the data provided - (1) Return of invested capital and the hurdle rate to the investors, (2) Catch up to the extent of 25% of the balance available to the manager, (3) 80% of the residual balance to the investors and (4) the balance of 20% as carry to the manager.

The distribution waterfall is provided below.

Waterfall Computation (Rs. Cr)	**Y1**	**Y2**	**Y3**	**Y4**	**Y5**	**Y6**	**Y7**	**Y8**
Cash inflow from realisations	0	0	0	100	500	800	1000	6900
Less Fees and Expenses	0	0	0	60	60	60	60	60
Distributable Cash Flow	0	0	0	40	440	740	940	6840
Waterfall Sequence								
Investors (Hurdle Rate and Invested Capital)	0	0	0	40	440	740	940	1460
Catch up at 25%	0	0	0	0	0	0	0	1345
Investors Further Return (80%)	0	0	0	0	0	0	0	3228
Carried Interest (20%)	0	0	0	0	0	0	0	807
Total Distribution to Investors	**0**	**0**	**0**	**40**	**440**	**740**	**940**	**4688**
Distribution to Manager								
Management Fees	20	30	30	30	30	30	30	30
Catch Up and Carried Interest	0	0	0	0	0	0	0	2152
Total Distribution to Manager	**20**	**30**	**30**	**30**	**30**	**30**	**30**	**2182**

It may be observed from the above table that in Y8, the amount received by the investors (INR 4688 crore) and the managers (INR 2182 crore) add up to INR 6870 crore which is the amount available for distribution after expenses. The management fees for Y8 have been included in the amounts receivable by the manager.

The formulae used to calculate the following are as follows:

- Catch-up: 25% of (Distributable Cash Flow – Hurdle Rate to Investors) i.e. 25%*(6840-1460) = INR 1345
- Investors' Further Return: 80% of Residual amount after Catch-up i.e. 80%*(6840-1460-1345) = INR 3228

- Carried Interest: 20% of the residual amount after Catch-up i.e. 20%*(6840-1460-1345) = INR 807

Step 11 – The ROI Metrics

It is now time to understand the ROI metric approach and compute the indicators discussed in the earlier paragraph. Accordingly, the DPI, RVPI and the TVPI for the distribution arrived at in the preceding steps are furnished below.

ROI METRICS									
		Y1	Y2	Y3	Y4	Y5	Y6	Y7	Y8
Distribution to Investors		0	0	0	40	440	740	940	4688
Paid in Capital	2000								
YoY DPI		**0**	**0**	**0**	**0.02**	**0.22**	**0.37**	**0.47**	**2.344**
Residual Value of Unrealised Inv.		500	1240	1200	1300	1500	1900	3000	0
YoY RVPI		**0.25**	**0.62**	**0.6**	**0.65**	**0.75**	**0.95**	**1.5**	**0**
YoY TVPI		**0.25**	**0.62**	**0.6**	**0.67**	**0.97**	**1.32**	**1.97**	**2.344**
DPI + RVPI		**0.25**	**0.62**	**0.6**	**0.67**	**0.97**	**1.32**	**1.97**	**2.344**

The paid-in capital in the above table is INR 2000 crore which is the total corpus including the green shoe option. It may be observed from the computation given above that the TVPI = DPI+RVPI.

Step 12 – The Investor Level Net IRR based on Distribution Waterfall

This is the last step in the required computations. The Gross and Net FIRR calculated in Steps 2 and 6 reflect the returns at the fund level but this is not what the investor gets since the final distributions are according to the carry arrangements between the investors and the manager. Accordingly, if we were to consider the third scenario of what exactly is the FIRR returned to the investor, it would be less than even the Net FIRR. This computation is furnished below.

Investor Net FIRR on Fund Maturity									
	Y0	Y1	Y2	Y3	Y4	Y5	Y6	Y7	Y8
Y1	-700	0	0	0	0	0	0	0	0
Y2	-700	-1300	0	0	0	0	0	0	0
Y3	-700	-1300	0	0	0	0	0	0	0
Y4	-700	-1300	0	0	40	0	0	0	0
Y5	-700	-1300	0	0	0	440	0	0	0
Y6	-700	-1300	0	0	0	0	740	0	0
Y7	-700	-1300	0	0	0	0	0	940	0
Y8	-700	-1300	0	0	0	0	0	0	4688
Investor Cash Flow	**-700**	**-1300**	**0**	**0**	**40**	**440**	**740**	**940**	**4688**
Investor FIRR									
Y8	**20.13%**								

As may be observed from the above discussion, the return perspective of fund performance can be judged in several metrics based on fund level and investor level approaches. Distributors need to educate prospective investors on the need to comprehend these intricacies such as Gross and Net IRR at fund level, FIRR at investor level based on actual distributions (which could be lower) and the TVPI. This will pave the way for better negotiations and meeting of minds between investors and fund managers. It will also greatly mitigate mis-selling by distributors, expectation gaps of investors and their consequent adverse impact.

Template of Important Risk Factors at Fund Level and Investor Level[98]

This is not intended to be an exhaustive list. The scheme related PPM would contain a more elaborate description and bigger list of risk factors.

A. GENERAL RISK FACTORS

1. Political, social and economic risks in India and how investments of the Fund can be impacted as a result of changes in the same
2. Risks related to global financial conditions
3. Impact of bankruptcy of portfolio vehicles/enforceability on ability of the Fund to earn returns
4. Risk of segregation of assets between funds/schemes/trustees not being available in third party suits/regulatory actions with respect to the Fund
5. Risk associated with the illiquid nature of the investment in the Fund (as may be applicable)
6. Risk of changes in accounting practices that may be adopted in relation to the Fund

B. RISKS RELATED TO PORTFOLIO INVESTMENTS IN PARTICULAR

1. Risk associated with the nature of the portfolio investments (type of company, type of instrument, pricing, non-controlling stake/minority interest, as may be applicable) and the possibility of inability of the Fund to deploy the entire capital raised
2. Risk related to the exit of the Fund from the portfolio investments and possibility of distribution in kind
3. Risk with regards to ability of the Fund to raise significant capital
4. Risk associated with the Fund investing with third parties
5. Risk associated with lack of insurance by the Fund against catastrophic events and other losses
6. Environmental related liabilities and risk to the Fund arising thereto
7. Risk associated with counter party's actions/default with respect to the Fund
8. Risk associated with change/change in control of parties in relation to the Fund
9. Risk associated with the managerial role the Fund may play *vis-à-vis* each portfolio company (example director seat/party to litigation/liabilities arising due to environmental damage, product defect, violation of government regulations and other similar liabilities)

[98] The list is compiled largely based on the disclosure requirements prescribed by SEBI in Section X of Annexure 1 to the Circular No. SEBI/HO/IMD/DF6/CIR/P/2020/24 dated February 5, 2020.

C. RISK RELATED TO FUND STRUCTURE

This section will be specific to the structure adopted and attendant risks associated with the structure. Certain common themes across fund structures could be:

4. Performance risks
5. Risk associated with the ability of the Investment Manager/management team to identify and structure investments and divestments.
6. Concentration risk.
7. Risk associated with reliance on forward looking statements/market data
8. Risk associated with reliance on the trustee, manager and other decision-making committees.
9. Risk associated with relying on third party service providers/intermediaries
10. Risk to investment on account of default on capital calls.
11. Restrictions on withdrawal and transfer and risk associated with this (including receiving in-kind distribution). Also, risk associated with AIF not being an assured return product to be included.
12. Risk associated with indemnity and tax obligation of the investors to parties to the Fund.

D. REGULATORY RISK FACTORS

1. Risk associated with obtaining SEBI registration and cancellation/suspension of SEBI certificate/other action by SEBI that may impact the operations of the Fund and Investment Manager.
2. Risk of uncertainty around the legal framework in which the fund/various parties to the Fund and portfolio entities operate in India. Also, risk in relation to litigation that may be faced by the Fund may also be highlighted along with the lack of jurisprudence as to certain aspects, in India.
3. Other regulatory risks including companies act, takeover code, enforcement risks, regulatory approvals including loss of registration etc.

E. TAX RELATED FACTORS

1. General Anti – Avoidance Rules and its impact on the Fund/ its investors/ portfolio investments and risks associated with it.
2. Risks associated with change in tax laws, including renegotiation of tax treaties, relevant to the Fund and its investors.
3. Change in administrative interpretation/ application of tax laws and attendant risks therefrom.

F. SECTOR SPECIFIC RISK FACTORS

This can include risks associated with the specific sector/ strategy that the Fund will be focussing upon as a part of its investment strategy and objectives.

G. CURRENCY RELATED RISKS

1. Risks related to currency fluctuations arising from offshore investments in AIFs.
2. Risks associated with investment in offshore jurisdictions in case the Fund intends to invest abroad.

Sample Questions: Chapter 6

1. One of the key risks of AIF investment is:

a. the risk of capital inadequacy

b. the risk of inadequate provisioning against NPAs

c. the risk of illiquidity

d. the risk of inadequate security creation

2. A fund has a PIC of 0.90. It means ________.

a. that the fund is about to complete its final close.

b. that it has only 10% NPA level

c. that the fund has 90% recovery rate on its investments

d. that it has drawn down most of the capital commitments

3. The FIRR is a measure of return based on the ___________.

a. time value of money

b. profit potential of an investment

c. accounting profit of an investment

d. percentage of gross margin

4. Macro-economic factors such as interest rates, currency risk and level of performance of the economy do not affect AIF performance since they invest in alternative assets. State whether True or False.

a. True

b. False

5. The MOIC of an AIF is the aggregate of its DPI and RVPI. State whether True or False.

a. True

b. False

CHAPTER 7: INVESTMENT PROCESS AND GOVERNANCE OF FUNDS

LEARNING OBJECTIVES:

After studying this chapter, you should know about:

- Various steps involved in deal sourcing
- Importance of Investment Due Diligence and its review
- Definitive agreements and other investor protection rights (dividend rights/ anti-dilution rights/ affirmative and veto rights/ exit rights etc.)
- Concept of Co-investments in AIFs
- Regulations in governance structure in AIFs

7.1 Deal Sourcing

This Chapter captures the broad discussion related to the process by which the investment manager identifies and completes the process of investment in an investee company, the steps involved in the process and the key learnings therefrom. At the outset, AIF fund managers are mandated to make investments in unlisted companies that show promise for growth and value creation. This in itself is an arduous task as these companies are not easy to find. They are not listed on the stock market, therefore, their presence is somewhat invisible. Secondly, their business and financial details are not available in the public domain as much as in the case of listed companies. AIF managers develop the expertise of not only identifying such companies but to zero in on the exact target investment which fits into their investment scheme and return requirements. Managers make use of their extensive network of business and professional contacts, services of investment bankers, consulting firms, practitioners such as auditors and legal firms, other AIF fund managers etc. to develop market intelligence and a database of potential companies that they could work on to generate deal flow.

Sourcing potential deals can be difficult and gruelling, but it is an essential skill required to be a fund manager in the AIF industry. Depending on the AIF's preference, a deal may be sourced through a variety of initiatives - internal analysis using a research support team, networking as stated above, making visits to various companies, company screens through databases for specific criteria, industry conferences and conversations with industry consultants and experts. Opportunities sourced through any of these means are referred to as 'proprietary sourcing' i.e., internally sourced. One of the key attributes of a successful AIF manager is to be able to showcase an impressive pipeline of deals to back up their pitch for raising the capital commitments from investors.

7.1.1 Initial Assessment

In addition to developing the deal flow, a lot also depends on how managers evaluate the potential of the companies they identify and the capabilities of the managements of such companies to deliver desired performance. Therefore, the initial assessment is largely about the potential business opportunity presented by the company and the credentials of the key management team (importantly the founders) and whether their vision, competence and drive match the requirements to convert the business opportunity into value creation.

Usually, companies seeking to raise capital from venture capital or private equity funds hire investment banks or consulting firms to provide professional assistance. A direct representation by the company is often counter-productive since most VC and private equity investors value the reference that the prospective client brings. Moreover, the company will have no idea of how to identify the type of investor it is looking for or would be ideal for the given situation. In addition, there would be no external validation of the company's testimonials. The company may also not have in-house expertise in deal structuring, valuation and negotiation with investors. It is therefore both a convention and a preferred route to appoint an investment bank or professional firm to conduct the deal on their behalf.

Usually, the investment banker sends out a 'teaser' or a 'flier' (a brief 1-3 page summary of the company and the opportunity) to prospective funds after identifying a list of funds or portfolio managers based on the business sector and investment criteria of the transaction. The fund manager who receives the teaser would need to decide whether a particular proposal has a preliminary fit into their investment scheme so that it can be pursued. Typically, about 25% of all the leads and enquiries coming into their fold are taken up for further processing.

If the investment team (investment managers supported by principals, associates and research team in the investment management company) finds the teaser interesting, they will negotiate and sign a Non-disclosure agreement (NDA) to receive the company's Confidential Information Memorandum (CIM or simply IM) prepared by the investment bankers. In a proprietary-sourced opportunity, investment teams will often sign an NDA directly with the target company in order to receive some confidential information regarding the company from management. The NDA is especially important to share important technical information and is used extensively as a matter of convention.

7.1.2 Business Due Diligence

At this stage, the investment team will perform some initial business and management due diligence to better understand the potential investee company. This process includes research on the industry, talking to advisors about the current state of the industry and players in it, and building and enhancing a preliminary financial model using the management's projections to understand the potential returns of making the investment. Meetings are also held with the investment bank to hear their thoughts on the financing requirements, type of financing and probable deal structure.

At an appropriate stage the bankers arrange meetings between the investment team and the key management team of the investee company to be able to understand their perspective (known as the 'Management Presentation'). The management team will present an overview of the company while the deal team on both sides will be engaged in technical discussions and better picture of the business case, numbers presented, current performance of the company and all associated aspects.

After reviewing the management's presentation and having initial discussions, the investment team will prepare a brief (2-3 page) investment proposal and present it to their Investment Committee.[99] The meeting can either be to alert the Committee on the potential deal or to commence the first stage of a formal approval process whereby an investment team would seek a 'go-ahead' to negotiate the deal. Sometimes, if the deal processing requires an approval on out-of-pocket expenses to be incurred, a 'cost-cover' may also be approved by the Committee. Once this process is completed, the potential deal is processed further and at the appropriate stage, the investment team has to decide to engage in deal negotiations with the company and its investment bankers.

7.1.3 Negotiations by Investment Manager

At this stage, further meetings are held to arrive at the refinement of the business plan presented by the investee company's management, fine-tune the investment and roll-out plan as applicable so that there is meeting of minds with the management on the future roadmap of implementation after the financing needs are met. This process is extremely important as it culminates into an agreement on the final business plan that would become the basis of the investment and the key deliverables from the company.

In parallel, the contours of the deal are also discussed with the investment bankers as well as the finance and regulatory teams of the company. The broad structure of the financing (debt/equity/mezzanine) are discussed and the appropriate regulatory framework at a broad level is also examined. The investment managers should also get a feel of the company's valuation expectations and to what extent it is negotiable.

[99] Managers of AIF may constitute Investment Committee to approve investment decisions of the AIF, subject to certain conditions. The Investment Committee would consist of senior management of the investment management company and nominated external members and independent professionals. This is discussed in detail in later section of this Chapter.

7.1.4 Preliminary Investment Memorandum and Term Sheet

Before proceeding to execute the term sheet, depending upon the protocols in the organisation structure of the investment manager, a Preliminary Investment Memorandum (PIM) may be presented to the Investment Committee detailing the proposed investment and deal structure in order to get an authorisation to sign the term sheet.

The investment team presents the potential investee company with a non-binding Letter of Intent (LOI) also called the 'term sheet'. This document is also sometimes referred to as Summary of Principal Terms (SOPT). The offer will detail a proposed transaction, investment amount (often a valuation range is given, rather than a specified amount), a proposed capital structure post-acquisition, board seat, key investor rights and management terms, exclusivity period, conditions precedent to investment and other residual matters. It may be noted that a term sheet is a non-binding document on both the parties and does not provide for any contractual rights whatsoever. It has a validity period within which the parties are expected to complete the transaction. The validity period is usually extendable by mutual consent if required. The role of the term sheet is to define the modalities avoiding vagueness and injecting precision into the transaction. It would also establish commitment from both sides (due to the exclusivity in the transaction) so that the transaction may be concluded expeditiously in the mutual interest.

Nevertheless, term sheets can be contentious and the company will do well to consult with its investment bankers and legal advisers to advise them on negotiating it and the legality of the various terms therein. Usually, investment bankers assist in the commercial negotiation on issues such as valuation and deal structure while legal counsel advise on negotiation of contractual rights in the term sheet and going forward, on the definitive agreements. The management team of the company has to focus on the compatibility of the investment management team of the AIF, its experience and value creation strategy and compatibility.

7.2 Due Diligence Review (DDR)

The DDR, sometimes known as 'investor due diligence' or 'IDD' refers to the due diligence to be performed by the AIF's investment manager on the potential investee company before firming up the investment. The due diligence process does not commence unless the term sheet is executed by both parties.

In the context of AIF investments, the DDR consists of a comprehensive examination into the facts, representations and affairs of the company by the AIF investment manager so as to take an informed investment decision. Normally, based on the coverage, a DDR can be broken down into the following components – (a) Business, Commercial and Technical DDR, (b) Financial DDR and (c) Legal DDR. The business and technical DDR is normally carried out by the investment team itself due to their in-house expertise and industry network. Sometimes they may engage technical experts to validate the findings or evaluate the technology if it is very specialised.

The investee company begins the process by providing more detailed confidential information in what is typically referred to as a 'virtual data room' to the investment team. Examples of data room records include constitutional documents such as memorandum and articles, board minutes and reports, books of account, tax returns, invoices, purchase orders, payroll statements, statutory filings, owned and leased property agreements, intellectual property documentation, employee lists and employment agreements, detailed segment financial information, and historical audited financials. The DDR teams usually draw up a schedule in consultation with the investee company's officials to conduct further discussions.

Follow-up due diligence calls are held (through the supervision of the investment bankers) with specific members of the executive and non-executive management team. Also, based on the data room files, the deal team start brainstorming the critical issues that they often require to fine-tuning the deal structure or conditions precedent.

Financial DDR covers the entire gamut of verification of books of account, financial statements and business transactions of the company with a view to determine the true and fair view of the accounts and financial statements, accuracy of the oral or written representations made by the company in its Information Memorandum (IM) and other literature, material financial information that is not disclosed and which may have a bearing on the investment decision or the agreed valuation and incidental matters. Therefore, a financial DDR almost amounts to a financial review of the company and is usually carried out for the past three financial years at least. In many cases, the scope of work may include vetting of the financial forecast of the company as represented in the IM and the consequent financial milestones. Financial DDR also covers the tax matters of the company, both direct and indirect. The DDR team examines the tax records, filings and assessments of the company and determines if there are potential threats that could lead to impending or future tax demands on the company including legal proceedings. The Financial DDR is usually carried out on behalf of the AIF's manager by an accounting firm or an investment bank engaged by such investor.

Legal DDR is normally conducted by a law firm practising in corporate law and transaction matters. The scope of legal DDR is to determine the legal aspects of the company's business, its Intellectual Property Rights (IPR) protection, its contractual relationships with third parties, material contracts and agreements entered into by the company and their legal implications, outstanding litigation if any and its possible outcomes, statutory compliance under various laws and defaults if any. Sometimes, DDR relating to compliance aspects may be covered under Financial DDR or conducted by a practising company secretary.

The DDR results in the investment manager being presented with confidential reports by the agency conducting the DDR. A copy of the DDR report is generally not made available to the company. However, where necessary, an extract of such report may be sent to the company for suitable clarifications or explanations. Sometimes, based on the DDR, the investment manager prepares a separate observation list and sends it to the company for responses and discussions.

Based on the due diligence report, the investment team start refining the financial model for the investee company based on forecast assumptions that are more realistic in the light of DDR findings. The financial model now presents a very detailed revenue and cost breakdown that is based on specific drivers and assumptions (e.g. price, volume, raw material costs, number of branches, number of customers, renewal rates, fixed vs. variable cost structure, etc.). All of these breakdowns combine into one model to describe the expected financial performance of the company in great detail. This gives the investment manager a complete idea of how to fix key deliverables on the investee company, how to drive deal performance and maximise potential returns from the investment. Many a time, this could lead to re-negotiations to modify and arrive at the final term sheet that could involve revision in valuation or disclosure statements, strengthening of the representation and warranties from the founders / shareholders / key management team. The final term sheet as executed once again between the parties becomes the basis for legal documentation.

7.3 Definitive Agreements

The term 'definitive agreements' is given to the set of binding agreements signed between the investee company and the investment manager representing the AIF to complete the investment transaction. Investment agreements consist inter alia of the following main contracts –

1. Share Subscription Agreement *(to be entered into between the AIF and the investee company)*	This agreement is the main transaction document that is executed in equity financing or investments wherein a new issue of shares by the company is required. The purpose of this Agreement is to detail the terms subject to which such financing/ investment is made by the AIF and provide for rights superior to those of an ordinary investor under the Companies Act as may be required.

2. Shareholders' Agreement *(to be entered into between all the existing shareholders of the investee company and the AIF. The company is made a party to it if there are clauses that provide privity of contract with the company)*	This is an inter-se agreement among shareholders which is intended to make them agree to the rights and obligation stipulated under the agreement. The necessity for this agreement arises due to the fact that equity investment conditions specified in the share subscription agreement are binding only on the company and not on its shareholders since they are not a party to it. In some cases, where the promoter owns all the shares or has control on other shareholders, a combined share subscription agreement may be entered into incorporating the provisions of a shareholders' agreement as well.

The share subscription agreement shall also contain provisions relating to reconstitution of the board of the company by appointment of the AIF's nominees, vacation of office if required, by existing directors, other key appointments if any and other such provisions as determined by the term sheet. Similarly, there could be requirements relating to appointment of managing director for a renewed term under new terms of appointment. There would also be clauses to outline several procedural requirements to accomplish the steps related to the implementation of the aforesaid provisions.

The main purpose of the shareholders' agreement on the other hand, is to bind all the existing shareholders to the conditions stipulated in the agreement. However, if there is an existing shareholders' agreement, care has to be taken to ensure that there are no multiple shareholders' agreements with conflicting provisions. In such case, all the existing agreements will have to be amended to bring all shareholders on common footing. Usually the latest agreement with all shareholder signatures would supersede all previous ones.

Associated legal documentation for the transaction may include management contracts with key management team of the investee company, additional financing agreements if any, undertakings or declarations from founders/ principal shareholders etc. The articles of association (AOA) of the investee company are amended to incorporate the provisions of the new shareholders' agreement so that it is enforceable.

7.4 Overview of Important Investor Protection Rights

7.4.1 Milestone Valuation

Quite often, venture capital investors will not wish to agree to a valuation based on future forecast at the time of investment since they don't know when the company would achieve profitability. Instead they peg the valuation to technical and/or commercial targets (milestones) being met. These milestones will be set out in the business plan. Failure to meet a milestone does not automatically mean that the investors will not provide the investment, but it may mean that it could lead to a downward revision in the valuation or a 'downround'[100] of follow-on investment or delay in future investments.

7.4.2 Dividend Rights

Investor may stipulate a prohibition on the payment of any dividend, which may be for a limited period of time. Even if the payment of a dividend is permitted, a common way of ensuring that a company is not obliged to pay dividends while it is growing is to provide the investors with a preferential right to dividend through the issue of preference shares[101] with a cumulative right so that the company can pay it out when it has sufficient liquidity. It may also be provided that the dividend accumulates and would be paid out as additional shares through a bonus issue (stock dividend). The company may also be prevented from declaring any dividend without the concurrence of the investor by providing them with an overriding right to veto the payment of any dividend. In addition, it may even be stipulated that the promoters are obliged to reinvest the dividend received as equity in the company on pre-agreed terms.

7.4.3 Anti-Dilution Rights

One of the most common type of anti-dilution rights is the 'pre-emptive right' of a shareholder which enables him to maintain his percentage of shareholding in the company by having the right to participate and purchase pro-rata shares issued by the company in future rounds of financing. This right is also enshrined in section 62 of the Companies Act. A pre-emptive right however, is only a right and not an obligation of the shareholder to invest in future round of financing. The articles of association may also be amended to stipulate any type of restrictions on the further issue of shares by the company.
In the context of VC deals since investments are made in early stages, the investor looks for downside protection first and returns later. One of the main risks in such investments is the risk of 'over-valuation' of the company if the valuation model is mostly contingent upon future growth parameters. In PE deals, investors tend to value immediate performance and have an outlook on the future while in a VC deal there has to be more reliance on future growth. Therefore, it is common to find that this risk is addressed more stringently in VC deals. In US and other developed markets, there is a lot of flexibility in providing protection

[100]A 'downround' refers to a particular financing round in which the valuation of the company is less than what it was in the previous round of financing. Downround may happen due to adverse performance by the company and / or due to external factors that may reduce investor confidence in the company.
[101]Preference shares may be issued by a company as provided under section 43 of the Companies Act 2013. They carry a first right to receive dividends and to receive repayment of capital on winding up of a company.

against this risk through an anti-dilution mechanism called ‘claw back’ or ‘ratchet clause’ in the agreements.

The basic principle on which the ratchet operates is that in the event there is a ‘down round’ subsequent to the investor’s investment, the investor will be compensated against the additional dilution. A down round means that the enterprise valuation of the company in that round of fund raising is lesser than that the previous round in such a way that investors in the later round are better off than those in the previous round. Therefore, the ‘clawback’ clause seeks to provide additional shares to the investor to compensate for the over-valuation of the company in the past. This protection usually functions by applying a mathematical formula to calculate a number of new shares which the investors will receive, for no or minimal cost, to offset the dilutive effect of the issue of cheaper shares.

Ratchets can be complicated in operation and need to be very carefully thought through due to tax and regulatory issues and in order to avoid conflicts of interest between the founders, the company and its other shareholders at a later date. Ratchets can be incorporated through bonus issue of shares, preferential allotment, cumulative convertible preference shares (CCPS) and equity warrants.

7.4.4 Affirmative and Veto Rights

Affirmative rights are those corporate actions that require the approval of the investors irrespective of the extent of their shareholding in the company. In other words, even if a particular action can be accomplished through an ordinary resolution (simple majority of 51%), an affirmative right will mean that such business cannot be carried through without such shareholder’s express consent. Affirmative rights are viewed as ‘positive control’, i.e. the power to influence corporate actions. Some of the standard matters on which affirmative rights are insisted by investors are the following –

1. Changes in the capital structure of the company by new issue of shares through preferential allotments or otherwise or a buyback of existing shares. The restriction on new issues is also known as a ‘pre-emption right’ on future capital issuances.
2. Alteration of the Memorandum and Articles of association.
3. Raising of secured debt or issuance of debt securities in excess of agreed limits.
4. Any type of new fund raising except renewal or enhancement of normal working capital limits.
5. Proposal to make an IPO or indirect listing or listing of debt instruments.
6. Making any investments other than in the ordinary course of business.
7. Any change in the business plan or activities of the company.
8. Spinning off or starting subsidiaries or divesting in them.

9. Any scheme or decision for a rearrangement, reconstitution, merger or amalgamation of the company.
10. The conveyance or other disposition of the assets of the company the value of the assets being in excess of an agreed value which are not in the Ordinary Course of Business.
11. The suspension or discontinuance of business activities of the company.
12. Any action to initiate winding up of the company.
13. Changes in the constitution of the board by appointment of new directors.
14. Appointment or removal of the auditors of the company.
15. Appointments, terminations and changes in the service conditions of employees comprising the key managerial personnel.

In contrast with affirmative rights, a veto right is to oppose a corporate action even if it has the requisite majority. It is also known as 'negative control' or the right of an investor to say no more as a defence to protect his own interests. Veto powers are insisted upon by investors in some of the corporate actions listed above as an alternative to affirmative rights. For e.g. the ratchet clause can be used even through a veto power on further issuances of shares by the company so as to protect dilution of the investor's equity in a down round.

7.4.5 Liquidation Preference

'Liquidation preference' is a right which can be required by the AIF in recognition of the risk it bears on its capital contribution. While there are many variations, the liquidation preference typically provides that, in the event the company is liquidated or subject to liquidation, the preferred shareholders will receive a certain amount of the proceeds in priority before any other shareholders. This preference amount may be equal to the amount of the preferred shareholders' investment, or a multiple of it applied in different complex combinations. The company distinguishes each round of fund raising by designating the issue of securities in different tranches such as Series A, B, C etc. as is normally the practice. The size and structure of the liquidation preference will be negotiated to reflect the risk inherent in each investment round, i.e. higher the risk, higher the required return. Many factors (including the valuation of the company) will be considered in this calculation. It is possible to structure economic rights of each series by stipulating different returns and liquidation preference rates for each series of preference shares or debentures.

7.4.6 Exit Rights

'**Right of First Refusal' (ROFR) and Right of First Offer (ROFO) -** These are contractual terms between shareholders which are provided in the Shareholders' Agreement. It may be understood that these are arrangements inter-se between shareholders and do not affect the company as such. If a shareholder wishes to dispose off shares that are subject to a first right of refusal, it must necessarily offer them for sale / first offer to those other shareholders who have the benefit of such right under the shareholders' agreement. Usually the right is specified in the context of sale to third parties by the promoters to the detriment of the AIF. The rationale behind a right of first refusal is that the existing shareholders must be provided with the benefit of increasing their stake in the company before offering such shares to a third party.

'Co-sale' and 'Tag Along Rights' - In the case of a 'co-sale' or 'tag along', if a shareholder wishes to dispose off shares that are the subject of such a right, the other shareholders who benefit from the right can insist that the potential purchaser agrees to purchase an equivalent percentage of their shares, at the same price and under the same terms and conditions. The rationale for this right is to have the effect of making the shares more difficult to sell. This is because, the AIF investors often bank on the strength of the technical and management experience of the founders and management. Therefore, they do not want these individuals to reduce their stakes or exit the company while they remain invested. Usually, the right of first refusal and tag along right are provided for simultaneously on the shares held by the promoters and key managers. In addition, investors may sometimes require a lock-in on such shares for a specified period.

'Drag Along Rights' - A 'drag along' right (sometimes referred to as '*bring along*'), creates an obligation on the other shareholders of the company (subject to such right), to sell their shares to a potential purchaser if the shareholder with such right chooses to sell to that buyer. For e.g. the AIF investor may have a drag along right on the promoters. Therefore, if it wishes to exit, the promoters will be obliged to sell to the same buyer on the same terms. A drag along is usually insisted when the AIF is a minority investor in the investee company. The objective is to drag the promoters along so that the stake that can be offered to the buyer would be large enough to attract a control or strategic premium thereby optimising the exit for the investor. In the absence of this right, sale of a minority stake could be difficult and sub-optimal due to minority or non-marketability discount.

7.5 Co-investments in AIFs

Co-investments are an integral part of the AIF investment paradigm when the investors wish to invest along with the fund directly into the investee company. In a co-investment arrangement, the investors in the AIF may partner with it to invest directly into one or more of the investments being made by the AIF. Although AIF fund managers are professionals in their own right and bring in considerable expertise in fund management, high fees and the poor performance by some fund managers can become an enabler to increased preference for co-investments by investors. Globally as well as in India, blind pools are slowly making way for more hybrid structures, wherein investors are demanding special rights to participate in co-investment opportunities alongside the fund, wherein while the investors take a call whether to invest or not, all other decisions in relation to the investment are taken by the investment manager jointly alongside the fund / blind pool. This is to ensure that the interests of the fund / blind pool are tied-in with the co-investors. A number of Canadian pension funds, for example, have established direct investment businesses. In principle, co-investments, either as sole investor or as a co-investor with a private equity firm, provides greater control for the investors in the selection of particularly attractive investments while saving on fees.

Recently, SEBI specified that co-investment by investors of Category I AIF and Category II AIF shall be only through a co-investment Portfolio Manager. The same has been discussed in detail in section 4.1.5 of this workbook.

7.6 Regulation on Governance Structure in AIF

The SEBI (AIF) Regulations, 2012 lay due emphasis on governance and conflict of interest issues in the administration of an AIF. Regulation 21 states in this regard that "the sponsor and manager of the AIF shall act in a fiduciary capacity towards its investors and shall disclose to the investors, all conflicts of interests as and when they arise or seem likely to arise. The manager shall establish and implement written policies and procedures to identify, monitor and appropriately mitigate conflicts of interest throughout the scope of business. Managers and sponsors of AIF shall abide by high level principles on avoidance of conflicts of interest with associated persons, as may be specified by the Board (SEBI) from time to time".

The above provisions make it mandatory for AIF governance structures to be robust and ensure that the sponsor, manager, trustee and other associated parties including service providers act with the highest level of transparency, integrity and trust for the interests of the unit holders (investors). There shall be written policies and organisational structure in place to ensure its compliance.

7.6.1 Role of Fund Governance

Fund governance is an important question to address. It has become important due to the gigantic size of the fund management industry with particular relevance to the AIF sector. AIFs take unsystematic risk with investors' funds due to which if funds are not governed well and fund managers do not adopt fiduciary responsibilities, the risks for investors become undefined. Several high profile fund failures resulting from fraudulent manager activity in developed countries (Madoff, Weavering, Petters, LTCM etc.), legal action by investors against managers (Medley), increased regulatory activity and volatile markets mean that investors are constantly at risk. Simultaneously, institutional investors and family offices /HNIs have become the primary source of investment for AIFs taking highly concentrated risks. Therefore, funds need to demonstrate the presence of governance structures in fund administration.

At its simplest, fund governance means the control structure within which funds are managed, directed and controlled. Manager oversight, outsourced independent valuation, segregation of functions, absence of conflicts of interest plus increased transparency and reporting are the central themes in fund governance. While fund managers play a key role there is a realisation that the fund governance framework also includes the roles played by key service providers such as custodians, prime brokers, administrators, investment advisors and distributors. Indeed, investors may rightly consider the regulator in the jurisdiction where the fund is domiciled to be part of the overall governance framework. While the control structure, including written policies and procedures, is important, good governance also requires a culture within the fund, the manager and other service providers such that investors' interests are of primary importance. Oversight board with sufficient independence, commitment and knowledge to understand the activities of the manager and other service providers can certainly ensure an appropriate control structure is in place and can help create a culture which improves the likelihood of investors' interests being prioritised.

It would be pertinent to note that fund governance also includes high quality engagement with the investee companies by the AIF manager. SEBI has mandated the exercise of 'stewardship responsibilities' by all AIFs (among other institutional investors) with regard to their investments in listed companies.[102] AIFs are expected to shoulder greater responsibility towards their clients / beneficiaries by enhancing monitoring and engagement with their investee companies. Stewardship is intended to protect their clients' wealth and promote fund governance. Stewardship responsibilities include monitoring and actively engaging with investee companies on various matters including performance (operational, financial, etc.), strategy, corporate governance (including board structure, remuneration, etc.), material environmental, social, and governance (ESG) opportunities or risks, capital structure, etc. Such engagement may be through detailed discussions with management, interaction with investee company boards, voting in board or shareholders meetings, etc. The principles laid down by SEBI for exercising stewardship responsibilities are briefly summarised below:

[102] Vide SEBI Circular No. CIR/CFD/CMD 1/168/19 dated December 24, 2019 and CFD/CMD1/CIR/P/2020/55 dated March 30, 2020.

- **Principle 1** - Institutional Investors should formulate a comprehensive policy on the discharge of their stewardship responsibilities, publicly disclose it, review and update it periodically. The policy should be reviewed and updated periodically and the updated policy should be publicly disclosed on the entity's website.
- **Principle 2** - Institutional investors should have a clear policy on how they manage conflicts of interest in fulfilling their stewardship responsibilities and publicly disclose it. The policy shall be intended to ensure that the interest of the client/ beneficiary is placed before the interest of the entity.
- **Principle 3** - Institutional investors should monitor their investee companies. Areas of monitoring which shall, *inter-alia*, include:
    a. Company strategy and performance - operational, financial etc.
    b. Industry-level monitoring and possible impact on the investee companies.
    c. Quality of company management, board, leadership etc.
    d. Corporate governance including remuneration, structure of the board (including board diversity, independent directors etc.), related party transactions, etc.
    e. Risks, including Environmental, Social and Governance (ESG) risks.
    f. Shareholder rights, their grievances etc.

  Identification of situations which may trigger communication of insider information and the procedures adopted to ensure insider trading regulations are complied with in such cases.
- **Principle 4** - Institutional investors should have a clear policy on intervention in their investee companies. Institutional investors should also have a clear policy for collaboration with other institutional investors where required, to preserve the interests of the ultimate investors, which should be disclosed. Circumstances for intervention may, inter alia, include poor financial performance of the company, corporate governance related practices, remuneration, strategy, ESG risks, leadership issues, litigation etc.
- **Principle 5** - Institutional investors should have a clear policy on voting and disclosure of voting activity. To improve governance of the investee companies, it is critical that the institutional investors take their own voting decisions in the investee company after in-depth analysis rather than blindly supporting the management decisions. Disclosure on voting policy may be made in annual reporting to investors and on the website of the AIF.
- **Principle 6** - Institutional investors should report periodically on their stewardship activities. Institutional investors shall report to their clients/ beneficiaries periodically on how they have fulfilled their stewardship responsibilities as per their policy in an easy-to-understand format. Such reporting shall be on the website and in periodical annual reporting to investors.

7.6.2 Fund Governance Structure

In a trust-based fund structure, the governance is centred on the AIF trust, the Investment Management Company (Investment manager, AMC) and the Trustee.

The AMC is concerned with all activities of a fund including its investment and divestment related decisions. Specifically, the manager has obligations under the AIF Regulations which are spelt out as follows -

(a) address all investor complaints;
(b) provide to SEBI any information sought by the regulator;
(c) maintain all records as may be specified by SEBI;
(d) take all steps to address conflict of interest as specified in these regulations;
(e) ensure transparency and disclosure as specified in the regulations.

SEBI has prescribed a detailed Compliance Test Report (CTR) to be filed by the investment manager at the end of every financial year to furnish the details of compliance with AIF Regulations and circulars issued thereunder.[103] (see Annexure 7.1) The CTR shall be submitted by the manager to the sponsor (and trustee if the AIF is a Trust) within 30 days from the end of the financial year. In case of any observations/ comments on the CTR, the trustee/ sponsor shall intimate the same to the manager within 30 days from the receipt of the CTR. Within 15 days from the date of receipt of such observations/ comments, the manager shall make necessary changes in the CTR, as may be required, and submit its reply to the trustee/ sponsor. In case any violation of AIF Regulations or circulars issued thereunder is observed by the trustee/ sponsor, the same shall be intimated to SEBI as soon as possible.

The Board of Directors of the AMC are entrusted with the overall supervision and oversight of the investment management functions of the AIF trust while the Trustee is responsible for the overall administration of trust matters. The investment functions, responsibilities and fiduciary obligations of the investment manager and the trustee are spelt out in the trust deed and the investment management agreement respectively in addition to provisions of law (specifically the AIF Regulations) that govern such positions.

7.6.2.1 Investment Committee (IC) Approvals

The Manager is responsible for investment decisions of the AIF. However, the fund management organisation (AMC or a fund management office run by managers) may

[103] Vide Circular No. CIR/IMD/DF/14/2014 dated June 19, 2014. The format prescribed by SEBI is provided in the Annexure to this Circular. For ready reference, it is also furnished at the end of this Chapter.

constitute an 'Investment Committee' (called by any name) to approve all the investment decisions of the AIF, subject to the following:[104]

(i) The Investment Manager of a Category I AIF/ Category II AIF may constitute an Investment Committee to approve the decisions of the Fund.

(ii) The members of the Investment Committee shall be responsible for the decisions taken and ensure that they are in compliance with the SEBI (AIF) Regulations. However, members of an Investment Committee set-up by a "large value fund for accredited investors" i.e. AIFs in which each investor, other than Manager, Sponsor, employees/ directors of AIF/ Investment Manager, has committed to invest minimum Rs. 70 crore or equivalent amount in other currency, shall be exempt and not held responsible, provided the members have furnished a waiver to the large value fund for accredited investors, in respect of compliance with the said regulation.[105]

(iii) The members of the Investment Committee shall abide by the Code of Conduct applicable to the Fund. (See section 4.1.15)

(iv) External members of the Investment Committee, whose names are not disclosed in the PPM or in the agreement made with the investor or any other fund document at the time of on-boarding investors, shall be appointed only with the consent of at least 75 percent of the investors by their value of investment in the Category I AIF/ Category II 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.[106]

Investment proposals are prepared by the investment team of the fund management office and put up to the committee/ manager for in-principle and final screening and recommendations. Each proposal usually contains the following information about the investee company:

- *Executive Summary:* Details of the proposed transaction, background, and overall deal team recommendation and investment thesis.
- *Company Overview:* History, description, products & applications, customers, suppliers, competitors, organizational structure, management team biographies, etc.
- *Market and Industry Overview:* Key market growth rates, trends, etc.
- *Financial Overview:* Historical and projected income statement, balance sheet, and cash flow statement analysis.
- *Risks and Key Areas of Due Diligence:* Potential risks to the industry/business and key areas of completed and ongoing due diligence.

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[104] Inserted by SEBI (AIF) (Second Amendment) Regulations, 2021, w.e.f. May 5, 2021.

[105] The format for such waiver is provided in the following link: https://www.sebi.gov.in/sebi_data/commondocs/jun-2021/Annexure%201-Waiver_p.pdf

[106] 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.

- *Valuation Overview:* Comparable company analysis, precedent and peer transactions analysis, DCF analysis, multiple based valuation analysis, etc.
- *Exit:* Exit strategy planned, exit options and anticipated timing of exit.
- *Deal Structure and Term Sheet Conditions*
- *Recommendations and Proposed Investment Size and Structure.*

The Manager/ Investment Committee examines every proposal with regard to (a) whether it conforms to the primary investment theme of the scheme, (b) performance, risk profile and management of the investment portfolio and (c) fund level risk concentration and compatibility to the return potential. The Manager/ Investment Committee has to consider the proposal with suitable recommendations to the Board for approval. The investment committee consists of both internal members and external independent members and experts who are not entrusted with the day-to-day management of the AMC to prevent conflict of interest.

It may be noted that in order to process the application for AIF registration and launch of schemes by SEBI, external members of the proposed Investment Committee (to be constituted for investment decisions) of such AIFs, must be resident Indian citizens. However, the applications for AIF registration and launch of schemes wherein the external members of the proposed Investment Committee (to be constituted for investment decisions) are non-resident Indian citizens, shall be processed only after receiving due clarifications from the Government and RBI.[107]

7.6.2.2 Investor Advisory Committee

Though, not a mandatory feature in Indian AIF structure, an Investor Advisory Committee consisting of majority Investor representatives may be constituted as a check and balance in the fund system. The Advisory Board's role is to provide informed guidance to the investment manager / IC of the fund based on its own assessment of the affairs of the fund from time to time. The Advisory Board may typically provide its recommendations to the investment manager / IC in relation to areas pertaining to conflict resolution, risk management, governance matters, investor-manager relations and reporting, statutory or tax issues of the fund that may need investor consideration and any other matters that it may find necessary for investor consideration. In some instances, any issues arising out of fund documents that may be of an administrative nature can also be looked into by the Advisory Board.

[107] Vide SEBI Circular No.: SEBI/HO/IMD/DF6/CIR/P/2020/209 dated October 22, 2020 on Processing of applications for registrations of AIFs and launch of schemes.

7.6.2.3 Role of Board of Directors of AMC

The Board of Directors (BoD) or Designated partner of the investment manager (AMC) play an extremely important role in implementing fund governance from the point of view of realizing the investment potential and serving the best interests of investors. Broadly the important areas of their fiduciary responsibility are listed below:

- BOD must ensure that the PPM, the periodic reporting under the AIF Regulations and other communications issued under its authority complies with applicable laws, that all conflict of interest areas and situations are addressed in the functioning of the AMC.
- BOD to put in place systems to ensure that the investment managers and the AMC team is not just compliant with law and regulation but also acts as per its fiduciary responsibility. No member of the BOD or the investment management team shall be in a position of conflict of interest.
- The terms to be approved for all service providers to the fund and the AMC under the investment management agreement are reasonable and consistent with industry norms and that the overall structure of the fund will ensure a proper division of responsibility among service providers. In particular, service providers have to be carefully chosen based on competence, appropriateness to fund requirements and based on a competitive search. It must be ensured that none of the service providers are in any position of conflict of interest in the performance of their duties.
- The directors should review reports and information they receive from the investment management team and auditors from time to time to independently assess the functioning of the fund and whether it is in line with the fund's investment strategy and compliant with the applicable laws.
- All investment proposals should be deliberated among the directors as required under the articles of association or board protocols and all aspects need to be considered. In particular, the proposal shall conform to the overall investment objectives and theme of the scheme / fund.
- The terms of appointment and remuneration package of executive, non-executive and independent directors should be commensurate to the role and functions expected to be discharged by them.
- The BOD shall evolve a policy and protocols to avoid related party transactions. In the event any specific transaction needs to be approved, the procedure laid out in the Companies Act, the articles of association and the Board policy need to be adhered to. Care must be taken to evolve the policy to outline mechanisms to identify and resolve potential conflicts. Suitable disclosures and measures that demonstrate governance and that the interest of the investors would be unimpaired, should be adopted.

- It cannot be over-emphasised that the BOD has to monitor fund performance, portfolio composition, investment strategies, efficiency and individual contribution of the investment management team, HR policy, audit, reporting and disclosure practices, statutory compliance and investor engagement by the managers. These functions require discharge on an on-going basis not only at board meetings.

7.6.2.4 Conflict of Interest Issues

One of the key aspects of an AIF administration is to put in place a Code of Conduct for the investment management team and to ensure that all connected parties including external service providers do not have any conflict of interest in the deliverance of their duties. In addition, they should not have any pecuniary interest or other conflicting relationships with the investee companies in which the AIF is invested. Fund performance reporting has to be compliant with law and established methods of valuation and should not be compromised. The interaction with external agencies such as investment bankers for deal sourcing, legal firms for legal and tax advice, accounting firms for due diligence, valuation and reporting, auditors for certification of the books of the AIF trust etc. are critical areas for high level of transparency, governance and ethics. These aspects are fundamental to achieving the desired standards of delivery of the fiduciary responsibility to investors in the AIF. Hence, in order to resolve potential conflicts of interest, the Sponsor or Investment Manager must:

- Disclose all potential conflicts of interests to the investors, as and when they arise or seem likely to arise.

- Establish and implement written policies and procedures to identify, monitor and appropriately mitigate conflicts of interest.

- Enforce high level principles on avoidance of conflicts of interest with associated persons.

The SEBI Circular on Stewardship Responsibilities (referred to in Section 7.6.1) lists out the following actions for addressing conflict of interest.

- Identifying possible situations where conflict of interest may arise. E.g. in case of investee companies being associates of the entity.
- Procedures put in place by the entity in case such conflict of interest situations arise which may, *inter alia*, include:
  - (i) Blanket bans on investments in certain cases
  - (ii) Having a '*Conflict of Interest'* Committee to which such matters may be referred to.
  - (iii) Clear segregation of voting function and client relations/ sales functions.

(iv) Policy for persons to recuse from decision making in case of the person having any actual/ potential conflict of interest in the transaction.

(v) Maintenance of records of minutes of decisions taken to address such conflicts.

- Periodical review and update of such policy and public disclosure.

7.6.2.5 Investor Grievances and Dispute Resolution

SEBI has a web based centralised grievance redress system called **SEBI Complaint Redress System (SCORES)** where investors can lodge their complaints against AIFs.[108] Complaints lodged against the AIF on the SCORES platform will be automatically forwarded to the AIF for resolution and reporting through the Action Taken Report (ATR). The ATR will be automatically routed to the investor who has filed the complaint.

For implementing an effective Investor Grievance Redressal Mechanism, SEBI has notified the SEBI (Facilitation of Grievance Redressal Mechanism) (Amendment) Regulations, 2023 and specified the Framework for handling of investor grievances received through SCORES. Based on these amendment regulations, AIFs shall redress investor grievances within 21 calendar days from the date of receipt of the grievance.

Investors can approach the **Online Dispute Resolution (ODR)** route or other appropriate civil remedies at any point of time. In case the complainant opts for ODR mechanism or other appropriate civil remedies while the complaint is pending on SCORES, the complaint shall be treated as disposed on SCORES. All claims, differences or disputes between investors and the AIF or its Manager arising out of or in relation to the activities of the AIF or its Manager shall be submitted to a dispute resolution mechanism that includes mediation and/or conciliation and/or arbitration, in accordance with the procedure specified by SEBI.[109]

All registered AIFs should ensure transparency in the Investor Grievance Redressal Mechanism. Hence, details of investor complaints received against Category I AIF/Category II AIF for each of their schemes, along-with the redressal status of each compliant, shall be disclosed to investors in the manner prescribed by SEBI.[110]

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[108] http://scores.gov.in

[109] SEBI Circular No. SEBI/HO/OIAE/OIAE_IAD-1/P/CIR/2023/131, dated July 31, 2023

[110] Vide SEBI Circular No.: SEBI/HO/IMD-I/DOF9/P/CIR /2021/682 dated December 10, 2021 on Publishing Investor Charter and Disclosure of complaints by AIFs.

Format of Compliance Test Reports (CTRs)

Name of the AIF:
Category:
CTR for the Year:
Contact details of the compliance officer:

Sr. No	Compliance with respect to	Details of compliance	Any other comments
1.	**Regulation 7(1)(c):** During the year, whether the AIF has informed the Board in writing, if any information or particulars previously submitted to the Board are found to be false or misleading in any material particular or if there is any material change in the information already submitted.		
2.	**Regulation 9(2):** Whether there has been any material alteration to the fund strategy during the year and in such case, whether consent of atleast two-thirds of unit holders by value of their investment in the AIF has been obtained.		
3.	**Regulation 10(b):** Whether each scheme of the AIF has corpus of atleast twenty crore rupees;		
4.	**Regulation 10(c):** Whether the AIF has added any new investors during the year. If yes, whether the AIF has accepted from an investor, an investment of value not less than one crore rupees.		
5.	**Regulation 10(d):** Whether the Manager or Sponsor has a continuing interest in the AIF of not less than two and half percent of the corpus or five crore rupees, whichever is lower, in the form of investment in the AIF and		

	such interest is not through the waiver of management fees. In case of Category III AIF, whether the continuing interest is not less than five percent of the corpus or ten crore rupees, whichever is lower.		
6.	**<u>Regulation 10(e):</u>** Whether the Manager and Sponsor have disclosed their investments in the AIF to the investors of the AIF.		
7.	**<u>Regulation 10(f):</u>** Whether each scheme of the AIF has not more than one thousand Investors.		
8.	**<u>Regulation 10(g):</u>** Whether the AIF has solicited or collected funds only by way of private placement.		
9.	**<u>Regulation 11(2):</u>** Whether the placement memorandum contains all information as specified in Regulation 11(2)		
10.	**<u>Regulation 12:</u>** Whether the AIF has launched any new scheme during the year and in such case, whether the placement memorandum has been filed with SEBI atleast thirty days prior to launch of scheme along with the scheme fees.		
11.	**<u>Regulation 13(5) & 13(6):</u>** Whether there has been any extension of the tenure of the close ended AIF. If yes, whether the same is not more than two years and approved by two-thirds of the unit holders by value of their investment in the AIF. In the absence of consent of unit holders, whether the AIF has fully liquidated within one year following expiration of the fund tenure or extended tenure.		

12.	**<u>Regulation 14(1):</u>** In case the units of the AIF are listed during the year, whether the listing is after final close of the fund or scheme.		
13.	**<u>Compliance with every clause of Regulation 15</u>** *(Separate compliance for every clause shall be provided)*		
14.	**<u>Compliance with every clause of Regulation 16/17/18/19, as applicable</u>** *(Separate compliance for every clause shall be provided)*		
15.	**<u>Compliance with every clause of Regulation 20</u>** *(Separate compliance for every clause shall be provided)*		
16.	**<u>Regulation 21:</u>** In case of any conflict of interests that have arose during the year, whether Regulation 21 has been complied with.		
17.	**<u>Regulation 22:</u>** Whether the AIFs have disclosed information contained in the clauses under Regulation 22 to the investors.		
18.	**<u>Regulation 23:</u>** *(Separate compliance for every clause shall be provided)*		
19.	**<u>Regulation 25:</u>** Whether the AIF, by itself or through the Manager or Sponsor, has laid down procedure for resolution of disputes between the investors, AIF, Manager or Sponsor through arbitration or any such mechanism as mutually decided between the investors and the AIF.		
20.	**<u>Regulation 28:</u>** Whether reports to be submitted the SEBI during the year have been submitted in the manner as specified by SEBI.		

21.	**<u>Regulation 29:</u>** In case the AIF has wound up during the year, whether Regulation 29 has been complied with.		
22.	**<u>Compliance with SEBI circular No. CIR/IMD/DF/10/2013 dated July 29, 2013 regarding Operational, Prudential and Reporting Norms for Alternative Investment Funds (AIFs):</u>** Compliance with respect to: • Risk management and compliance • Redemption norms • Prudential requirements		
23.	**<u>Compliance with circular No. CIR/IMD/DF/14/2014 dated June 19, 2014</u>** Compliance with respect to: • Disclosures in placement memorandum • Every clause under point (3) on 'Clarification on certain aspects of the AIF Regulations'.		
24.	**<u>Compliance with any circular as issued/may be issued by SEBI</u>**		

Sample Questions: Chapter 7

1. The due diligence review is conducted by ________.

a. the trustee of the AIF

b. the auditor of the AIF

c. an agency appointed by the investment manager

d. an investment bank appointed by the manager

2. The term sheet is entered into by __________.

a. the manager with a potential investee company

b. the sponsor with the investor

c. the fund with the manager

d. the distributor with the investor

3. The following is a 'definitive agreement' for an AIF investment.

a. Private Placement Memorandum

b. Subscription agreement

c. Articles of Association

d. Trust deed

4. A 'ratchet' protects the AIF from a future down round. State whether True or False.

a. True

b. False

5. 'Affirmative right' means the right to exit the company. State whether True or False.

a. True

b. False

CHAPTER 8: FUND DUE DILIGENCE – INVESTOR PERSPECTIVE

LEARNING OBJECTIVES:

After studying this chapter, you should know about:

- Importance of Fund Due Diligence by Investors
- Criteria for fund selection (ownership structure/ continuing interest/ alignment of interest etc.)
- Evaluating the performance of Fund Managers
- Need for Fund Benchmarking
- Importance of sales strategy formulation by distributors

8.1 Investor Perspective

This Chapter discusses the aspects relating to fund selection process and due diligence to be done before an investor decides to become contributory to a particular AIF. Since the distributor plays an important role in the marketing of AIF schemes and the consequent fund selection by an investor, it is important for distributors to understand the importance of investor perspective.

The distributor's understanding of its investor is based on three important criteria – (1) risk profile and investment requirements of the investor, (2) the fund structure and governance aspects and (3) profile and performance track record of investment manager. As a first step, the distributor should have detailed discussions with the prospective investor to formulate a unique customer-specific risk profile. This would be based on seeking specific information on investor's investment objectives, intended tenure of investment, risk appetite, return expectations, liquidity requirements, if any, during the investment period and other relevant information. A distributor may do well to create a questionnaire for this purpose. Through this process, the distributor gets to understand the investor profile better and establish product compatibility before marketing specific AIF schemes. For e.g. a particular investor such as a pension fund may be less risk-oriented focussing mainly on steady long term income. For such an investor, recommending equity growth-oriented AIF may be incompatible with its fundamental risk-profile. Instead, a debt fund that seeks to invest in rated debt instruments, operational special purpose vehicles, infrastructure investment trusts or real estate investment trusts that offer steady long term cash flow may be a better fit.

Based on the investment strategy of the investor and the resulting portfolio design, a wish list of scheme characteristics needs to be established. The wish list defines the types of AIF schemes / products that are consistent with the investment strategy of the investor. Based on this finding, a shortlist of AIF schemes / products may be formulated by the distributor that fit a particular investor. Distributors need to map the investment objectives of each investor with the fund's investment objectives and other aspects such as tenure of the fund, is it Category I or II AIF, is it a pure debt fund or equity fund, is it a sectoral fund or a sector agnostic fund and so on to assess the fitment of the fund / scheme to the investor. One investor's requirements cannot be universally applied to market AIF products to other investors.

8.2 Fund Selection Criteria

After drawing up the schemes/ products that are compatible to investor profile and requirements, the next step for a distributor would be to identify the appropriate AIFs from among the available choices that would be marketed to respective investors.

At the highest level, three factors are fundamental in the fund selection process by an investor – (a) ownership structure and continuing interest, (b) alignment of interests and (c) competing or outside interests. These three factors are discussed below –

8.2.1 Ownership Structure and Continuing Interest

Under the AIF Regulations, it is mandatory for the sponsor/manager to have minimum capital commitment and continuing interest in the AIF (see section 3.3). Therefore, one of the primary concerns for an investor is to verify the level of commitment. The fund structure is more relevant to examine whether the sponsor, investment manager and the fund (trust or LLP) are structured at arm's length with each other, whether there are related parties in the fund structure or are in the third parties engaged as experts/ service providers etc. The verification of the ownership structure and the commitment/continued interest would provide preliminary comfort to the potential investor before a fund due diligence is conducted. This is due to the fact that continuing interest provides the 'skin-in-the-game' for the manager and removes one of the main sources of mis-alignment of interests and moral hazard for the investors. Many first time managers would invest more than the mandatory minimum continuing interest to provide greater comfort to investors.

8.2.2 Alignment of Interests

The main areas where alignment of interest between investors and the sponsors/ managers is required are – (1) Sponsor/manager commitment, (2) Management Fee and Additional

Return / Carry terms including super-carry or higher carry after a higher preferred return,[111] (3) Distribution Waterfall, (4) Catch-up and Clawback, (5) Competing or outside interests for the manager, (6) transparency and governance in fund structure and reporting, (7) related party transactions by fund / manager and (8) Co-investment opportunities. All these areas are important for potential investors to verify and negotiate firmly during due diligence or discussions for execution of subscription agreement with the fund. Hard negotiations by investors are driving down management fee and expense structures and making it difficult for managers to aspire for higher carry/ super carry and catch-up clauses in the investment management agreements.

8.2.3 Competing or Outside Interests

While investors would seek to ensure that the manager's time and efforts are used in the best interests of the Fund/Scheme/Firm they invest in, it is possible sometimes that due to the structure of the fund or otherwise, there could be competing or outside interests that may conflict with their interest. For e.g. referral of investment deals to a particular scheme or fund may be affected if the fund manager is managing several funds or schemes or is involved with other business interests outside the AIF. It is also necessary to verify if the investment manager has other outside interests in business ventures, other AIF interests or other business obligations that may compromise the time devoted to the fund management. Similarly, there could be outside engagement of service providers, professionals who may be benefiting the manager but their service fee may be charged to the fund. These kind of arrangements and conflicts need to be looked into by the investors at the time of fund due diligence and suitable negotiations are required to protect against their downside.

Conflict due to outside interests may also arise when financing deals or board positions held by manager in investee companies can compromise the interests of the AIF. This can arise when the portfolio company is distressed or is in negotiations with other investors or funding sources. Further, such director may have some disclosure issues when certain portfolio company information is under a non-disclosure agreement but his/her duties to the AIF would require disclosure of this information. Suitable framing of nominee directorship policies by the fund and incorporation of some of these provisions in the investee company documentation would address this issue. Investment managers should also disclose fees and equities received by its employees from portfolio companies for services rendered. Investors may verify the policy with regard to such practices at the time of fund due diligence and on-going reporting by the manager.

[111] Super carry or higher carry is a term used to denote higher additional returns charged by highly sought after funds that have a very high return track record in fund performance. Since these funds are in high demand from investors, they tend to negotiate higher additional return than industry norm. In some instances, super carry may be in the interests of investors if they negotiate a super carry in lieu of higher management fee to the fund manager.

8.3 Evaluating the Fund Manager

From an investor perspective, selection of the right type of AIF to associate with depends largely on the selection of the investment manager. This is not a simple process and if not executed properly can lead to the risk of adverse selection. Manager selection is not mechanical process but requires industry experience and resources to conduct both research and due diligence.

Generally, the AIF eco-system relies on relationships between investors and fund managers based on their track record of past performance, credentials of work experience and prior association. Therefore, existing well-performing managers and their funds are in high demand. Frequently, when a fund manager with a proven track-record of fund performance raises a new fund, investors in previous funds quickly commit, often leading to oversubscription. The key criteria in evaluating managers would be the following:

1. Fund management experience in earlier assignments
2. Performance track record in delivering returns
3. Specific expertise in the proposed fund / scheme's investment strategy
4. Expertise in exit management and successful exits in the past
5. Litigations, write-downs, write-offs and liquidations or such other adverse events faced in past fund management
6. Instances of conflict of interest, strained relations with investors, non-compliance issues with regulators, litigation proceedings with investee companies or with investors etc. that reflect on the conduct of the managers.

These factors weigh very heavily on investor's investment decision as they would determine the assessment of the fund manager.

Investors also tend to rely more on existing manager relationships which may have delivered good results in the past. Finding new managers is also a difficult and expensive exercise for investors as the due diligence process has to be conducted much more exhaustively for commencing a new relationship. Sometimes, investors may perceive additional risk of uncertainty in fund closures in the case of new AIF managers. Nevertheless, distributors may provide a value add in this area by bringing newer AIF schemes/ products launched by lesser known managers to the attention of investors that may fit their criteria and risk profile and thereby enable them to broad-base their AIF portfolio. In the long run, it would be a significant contribution by distributors/ Advisors in the development of a deeper AIF industry.

8.4 Importance of Fund Due Diligence

As fund selection is one of the key drivers to favourable outcomes in AIF investing strategy, fund due diligence is a requirement for prudent investors as well as the basis for better investment decisions. The due diligence process covers all the activities associated with evaluating an AIF and is commonly defined as "the process of investigation and evaluation, performed by investors, into the details of a potential investment, such as an examination of operations and management and the verification of material facts".[112] In the context of AIFs, the phrase 'due diligence' has to be interpreted slightly differently. AIF investment products are marketed privately and are, therefore, essentially meant for informed investors. Such investors are expected to conduct their own due diligence before investing to safeguard their investments. Potential investors need to realise that while distributors' assessment of a fund's appropriateness is the first step to fund selection process, the final decision would have to be based on their own final assessment. This would require a process of due diligence to be conducted on the fund and the investment manager.

From a service perspective, it is necessary for a distributor to ensure that investors are provided with sufficient information about the prospective AIF and its manager to make an informed decision after the completion of their due diligence. Distributor has to play a significant role in enabling this process by providing necessary assistance to investors to procure the required information from the fund documents and through direct solicitation from the fund offices.

8.4.1 Scope and Uniqueness of AIF Due Diligence

As information on AIFs is not publicly available, the main source of information is the PPM circulated by the fund for a proposed scheme. In addition to the PPM, it is necessary to collect additional information from the respective fund house or office of the investment manager. The management of this activity is seen as the main source of competitive advantage for a potential investor. An illustrative questionnaire/ set of information that may be sought for an investor due diligence is provided in the Annexure 8.1 to this Chapter.

Due diligence is generally based on cross-referencing and cross-checking, but often the lack of suitable comparable and information makes the analysis highly subjective. The high reliance on qualitative aspects and judgment can obscure potentially good AIF opportunities. For example, in many cases, newer AIFs are avoided, not necessarily because the fundamentals are not right but simply because not all points of the due diligence can be supported by tangible evidence. Let us consider a sector specific AIF that focuses on infrastructure sector. The fund manager may have specific expertise in identifying several

[112] www.investorwords.com

emerging opportunities in the sector due to prior expertise. But investors may overlook the fund due to prevailing sectoral issues or general discomfort with long gestation and high risk factors. In such cases, the manager may not be able to provide enough prior evidence of transactions since some policy changes may have opened new doors very recently.

In some cases, once a reputable institutional investor has provided capital commitment, other investors tend to place credibility and believe that it has carried out a proper due diligence. However, it is necessary to appreciate that every investor may have specific required outcomes from a due diligence process. Investors should not take comfort from the fact that a large institution has provided capital commitment to an AIF and therefore it is investment-worthy.

Considering the unique elements of fund due diligence, the following broad approach is useful for fund selection –

1. **Quantitative Selection** – It would be necessary to develop a template of quantitative investment criteria for fund selection based on specific investor requirements that would narrow down the fund selection process. Fund management teams that meet the objective criteria such as investment horizon, hurdle rate, past performance record, capital commitment, drawndown phase etc. can be short-listed for each investor.
2. **Investment Management Team and Infrastructure** – Alternative investments are based critically on the skills and attributes of the manager. Furthermore, the management team needs to be supported by sufficient analytical resources (macro, equity, credit) to effectively implement their investment process. Through necessary interviews and background checks, it is necessary to assess the quality of the team and identify their strengths in identifying investment opportunities and generating superior returns. The organisational structure of the management company also needs to be reviewed to ensure there are adequate processes in place to institutionalise the management function. A review of the adequacy of staffing and compensation structures of the management team is also an important part of the due diligence.
3. **Investment Process Review** – The entire management function that ranges from identification of investee companies till exits are made, decision-making process, checks and balances in decision-making, quality of research and methodologies and risk management practices are important in this segment of due diligence.
4. **Past Performance Review** – Suitable inputs can also be obtained by a review of the past performance of the fund / manager with a peer comparison and benchmarking to listed markets to explore alpha generation potential. Assessment needs to be made as to how a manager has driven performance and how that reflects in the track record, whether it is consistent with the fund philosophy and investment regulations,

To sum up, while scheme/ product assessment and customised marketing by distributors to investors is required at the first level, it has to be followed by fund due diligence to be conducted by investors at the next stage before firming up capital commitments.

8.5 Broad Aspects of Fund Due Diligence

The broad aspects of fund due diligence from an investor perspective are listed below –

- **Fund / Scheme Details** - Description and investment theme, tenure and capital commitments received if any, deal pipeline for investments in investee companies if any, timelines for closings etc.
- **Sponsor / Manager Commitment** – Whether the Sponsor/ Manager has maintained the minimum or higher commitment.
- **Investment Manager** - Fund manager profile, track record, profile and complete details of the investment management team, previous investor profile and repeat investors.
- **Hurdle rate / target returns –** Hurdle rate in the context of AIF investments is the rate of return from the fund that a fund manager has to achieve before being entitled to any additional return or incentive. Therefore, the hurdle rate if achieved by the fund fully accrues to the investors. If hurdle rate is fixed too low in comparison to the general market returns (say 8 to 10%), it would mean that the fund manager's task becomes easier and they may get a higher share of additional return or incentive. On the contrary, if the hurdle rate looks too ambitious (say 25%), it is possible that the fund manager may be tempted to try too hard and take undue risks in trying to achieve it so as to be entitled to their incentive. Therefore, hurdle rate should be fixed reasonably and in context (say 15% in the Indian context). In addition, the fund manager may mention a target return that they intend to achieve from a prospective scheme or fund. This would provide enough guidance to investors as to the level of risk taking being proposed by the manager.
- **Key Man Clause** - A key man clause in a fund agreement is a contractual clause that prohibits an AIF / management company from making new investments if one or more key persons are not available to devote the necessary time to the investment. A key man is an important employee or executive in the investment management company including the managing partner/ director who is critical to the operation of the fund management. The ill-health, death, absence, or disability of such a person may have a significant negative effect on the operations and outcome of the fund performance. Key man possesses the skills, knowledge, leadership abilities, and experience that are considered crucially important for the AIF. Investors place significant reliance on the track record and

representations made by the manager during fund due diligence/ capital commitment phase.

A key man clause serves as a form of guarantee that the Fund/ Firm makes to the investors, assuring them that only the most qualified and senior executives handle important decisions. Since investments may remain in place for several years in an AIF structure, the continued availability of such persons is critical. In India, several new funds are getting floated and many a time, senior talent from AMCs quit, to start their own funds as managers. In such a scenario, funds are exploring ways of broad-basing management teams and increasing the commitment of key personnel. Concepts of 'super key person' and 'standard key person' are increasingly becoming common. For e.g. if a fund has four founding partners, each of them is a key person and all of them are involved in day-to-day fund management. However, if, for e.g. two of them are senior partners who are responsible for capital commitments and investor relationships and the other two are in charge of over-seeing the fund management function, the senior partners can be the 'super key persons' and the junior partners could be the 'standard key persons'. In addition, there could also be a few senior executives from the investment team who may also be included in 'standard key persons' as they may be transactions team leaders or responsible for reporting functions.

- **Capital Commitment Details** – Minimum and maximum proposed, Drawdown schedule proposed, investment period, co-investment option etc.
- **Commercial Terms** – Proposed Management Fee, Fees & Expenses details, Additional Returns or Carry, Distribution Waterfall etc.
- **Fund Performance** - Past performance details of the AIF, other existing schemes, other past AIFs managed by the fund managers, details of landmark deals and exits. This can be measured in terms of fund level FIRR both gross and net (post all fees, expenses and carry) and Investor Level FIRR (post fee and carry). These aspects have been discussed in an earlier Chapter.
- **Investment strategy** – Sweet spot investment size and profile, sectoral focus if any, initial investments, follow-on investment provisions, number of deals targeted, exit strategies planned and proposed timing, deal flow and filtration process, percentage of hit rate, exposure limits to a single company etc.
- **Debt Financing Strategy** – Specifically applicable factors for debt funds such as type of debt investments planned, debt protections such as securities, collaterals, default history if any, recovery mechanisms, debt resolution strategy, past performance track record if any.
- **Fund governance structure and policies** - Fund administration and internal processes, composition and functioning of investment committee, board of directors of AMC, trustee, custodian, auditors, documentation and deal process, policies for elimination of conflict of interest, insider trading etc.

- **Fund Reporting Systems and Winding up** – Periodic reporting systems, formats, annual reporting, statutory reporting to SEBI, other statutory compliance, investor engagement processes, winding up process.

8.6 Fund Benchmarking

One of the aspects that can be a challenge for investors seeking to invest in AIFs is the absence of a proper benchmarking system to identify and rank funds according to their performance. Since most funds make marketing pitches to project top-quartile performance, it would be difficult to benchmark, especially in the case of new funds or funds with exotic themes or new schemes.

SEBI issued a couple of circulars on disclosure standards for AIFs.[113] SEBI has mandated to develop an industry benchmark to compare the performance of AIF industry against other investment avenues including global opportunities. The AIF industry, therefore, is required to introduce

- Mandatory benchmarking of the performance of AIFs (including Venture Capital Funds) and the AIF industry
- A framework for facilitating the use of data collected by Benchmarking Agencies to provide customized performance reports

In terms of the above, SEBI has mandated the following:

a) Any association of AIFs which in terms of membership, represents at least 33% of the number of AIFs, may notify one or more Benchmarking Agencies, who shall enter into agreement with each AIFs for carrying out the benchmarking process.
b) The agreement between the Benchmarking Agencies and AIFs shall cover the mode and manner of data reporting, specific data that needs to be reported, terms including confidentiality in the manner in which the data received by the Benchmarking Agencies may be used, etc.
c) AIFs, for all their schemes which have completed at least one year from the date of 'First Close', shall report all the necessary information including scheme-wise valuation and cash flow data to the Benchmarking Agencies in a timely manner.
d) The form and format of reporting shall be mutually decided by the Association and the Benchmarking Agencies.
e) If an applicant claims a track-record on the basis of India performance of funds incorporated overseas, it shall also provide the data of the investments of the said funds in Indian companies to the Benchmarking Agencies, when they seek registration as AIF.

[113] 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.

f) In the PPM, as well as in any marketing or promotional or other material, where past performance of the AIF is mentioned, the performance versus benchmark report provided by the benchmarking agencies for such AIF/ Scheme shall also be provided.
g) In any reporting to the existing investors, if performance of the AIF/ Scheme is compared to any benchmark, a copy of the performance versus benchmark report provided by the Benchmarking Agency shall also be provided for such AIF/ scheme.

SEBI in its circular has laid down the operational guidelines for implementation of performance benchmarking as provided in Box 8.2 below:

Box 8.2: 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 31^{st} 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 AIF Regulations.
(e) Data provided for March 31 of every year shall be audited data and for September 30 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.

SEBI has notified that Manager of AIFs shall timely report valuation of investment portfolio to performance benchmarking agencies.[114]
In addition to the standard benchmark report prepared by the Benchmarking Agencies, if any AIF seeks customized performance reports in a particular manner, the same may be generated by the Benchmarking Agencies, subject to:

i. Consent of the AIFs, whose data needs to be considered for generation of the customized performance report.
ii. Terms and conditions, including fees, decided mutually between the Benchmarking Agencies and the AIF.

However, benchmarking shall not apply to the Angel Funds registered under sub-category of Venture Capital Fund under Category I AIF.

Currently, there are three benchmarking agencies appointed by the Indian Private Equity and Venture Capital Association (IVCA)[115] and have published AIF benchmarks for all

[114] SEBI Circular No.: SEBI/HO/AFD/PoD/CIR/2023/97 dated June 21, 2023 on Standardised approach to valuation of investment portfolio of AIFs.
[115] https://www.ivca.in/resources/performance-aifs

Categories of AIFs, in USD and INR terms. These benchmarks, published by CRISIL, NSE and Preqin, cover performance data of the AIFs.

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

8.7 Sales Strategy Formulation by Distributor

Distributors have to largely focus on PPM disclosures made by the AIF and prepare a product literature to be able to outline the scheme and how it fits into a specific investor's requirement. This approach would be helpful in marketing to investors directly or through portfolio managers and family office investment heads. The sales strategy shall largely relate to the key features of the scheme as and how they suit the investor's target risk and return profile, time horizon for investment, comparative assessment with regard to other AIF and non-AIF investment alternatives, how the capital commitment requirements of the proposed AIF fit into the investor's overall portfolio allocation, how the investment management team is compatible with the investor's expectations and how the distributor expects that the investor's proposed investment would satisfy the broad AIF investment strategy. These aspects have been highlighted in the discussions in this Chapter and should be considered fundamental to the sales promotion strategy.
Let us consider a few case-lets to illustrate the point.

Case 8.1:

XYZ Distributors is an AIF distributor. The firm has targeted relationships with HNI investors for distribution of AIF products. The firm has made marketing pitches with potential investors and has compiled investor profiles. One of their investors is Star Pension Fund that has an alternative investment allocation in its fund portfolio. The fund seeks medium risk-oriented AIF opportunities with a time horizon of 6-7 years with interim payout possibility after 3 years. The hurdle rate expectations are about 7-8% and management fee terms should be in the range of 1.5% preferably with a lower additional return of 10% to 15%. What type of AIF profile would suit Star Capital's requirements from the given alternatives below?

a) A high technology AIF that seeks to invest in new age digital companies in emerging areas of financial technology, artificial intelligence and data analytics.

b) A real estate AIF scheme that seeks to co-invest primarily in land bank acquisitions with real estate developers and financing of large projects in emerging sectors such as warehousing and logistic parks.
c) An alternative debt fund that invests in unlisted long term bonds and secured debentures issued by real estate SPVs with operational leases in sectors such as Co-working office spaces and co-living housing units. The fund is also financing new projects that are under construction and would commence their leases in the next 2-3 years.

Given the investment profile of Star Pension fund, option (c) is the best fit through the commercial terms; for management fee needs to be negotiated.

Case 8.2:

ABC Alternates Pvt Ltd is an AIF manager in the process of launching its new fund with focus on emerging opportunities in companies that are developing technologies for clean energy, self-sustainable buildings, waste recycling, soil rejuvenation and other environmental sustainability businesses. The AIF plans to invest both in equities and green bonds to be issued by such companies. The fund's investors need to be primarily institutional players and wishes to target green technology investors from overseas as well. From the following alternatives, which investor profile is the best fit for ABC's investment strategy?

a) HNI investors based in Silicon Valley who are technology oriented and would like to invest in AIFs that are actively pursuing cutting edge technology ventures in digital graphics, 3D effects and printing, Internet of Things, digital diagnostics, bio-technology and next generation big data analytics,
b) Domestic Institutional Investors that are looking at AIFs that invests in social ventures, development of sustainable societies and ESG ventures.
c) An Institutional Consortium from Europe that seeks to invest in AIFs targeting clean energy assets and technologies with a long term view on growth and wealth creation.
d) A large Middle-eastern sovereign wealth fund that seeks to invest in AIFs that have focus on strategic energy assets in hydro carbons, gas fields and remote offshore exploration.

From the given alternatives, the investor consortium at (c) above is the best fit for ABC Alternatives. Though the investor group at (b) above is also targeting AIFs with ESG focus, the investors at (c) are focused on technology development ventures for ESG sectors and are therefore more closely aligned to the investment objectives of ABC Alternatives.

In order to achieve an effective sales strategy and product optimisation, distributors need to spend time understanding investor requirements, identify AIF schemes that match the requirements more closely and prepare effective sales pitches that communicate well with investors. The value addition of the distributor should be evident in terms of high quality product research work, application of thought and effective communication. The mapping of product compatibility to specific investor requirements and vice versa is the corner stone to building the reputation of a good AIF distributor profile.

ANNEXURE 8.1

Illustrative Fund Due Diligence Information and Questionnaire

It has been the endeavour to provide as wide and exhaustive a list as possible to educate the reader on all the Fund/ Firm matters that a potential investor may be concerned with prior to taking an informed investment decision. The extent of the due diligence process would however depend on facts and circumstances of each case and the extent of disclosures already available in the PPM. Discretion has to be exercised by the investor due diligence team in making an appropriate questionnaire to serve individual requirements. On the same lines, distributors may go through the PPM and seek additional details as may be possible from the Fund/ Firm to make their own sales pitch and product information to their clients and advice on the scheme/ product based on its compatibility with investor objectives. This would greatly enhance distributor value add in the process and reduce mis-selling possibilities.

Fund Structure: General Information

- Provide a brief overview of the AIF Sponsor and the Investment Manager, the Fund Structure, including information on the founding, subsequent history and information on any predecessor firm and/ or parent firm, changes in ownership since inception. Describe any plans to change or expand the AIF Structure including other schemes if any and proposed growth strategy.
- Provide the legal and tax structure of the Fund. If available, provide a tax-structuring opinion provided by an external legal counsel that describes tax treatment under the Income Tax Act 1961.
- Provide an overview (including chart) of the Investment Management Company (AMC) management/ organisational structure including back office personnel and their job description. Discuss the AMC's delegation of authority and succession plans.
- Details of Investor Advisory committee formation and seat eligibility criteria, if any.

Track Record, Performance, Governance, Compliance Related Information

- Track record of past funds and key investment team members.
- Round wise details of past funds' investments.
- Portfolio level IRR, both gross and net (post all fees, expenses and carry).
- Investor level IRR (post fee and carry) - based on drawdowns and distribution to the investors.
- Details of exits made with IRR and cash flows.
- Provide examples of active/ exited investments with investment multiple (TVPI) above and below 1.0x. Discuss what went wrong in the difficult cases, action taken, lessons learned and how (and when) outside experts were brought in.
- Co-investors/ co-lenders for the past deals.
- Key institutional investors in past and current fund.

- Repeat Investors: How many investors (number and amount) have been repeat investors in the past funds?
- Describe any qualified audit opinions received by the Firm's portfolio investments during the Firm's period of ownership. Provide the latest audit report for the Fund/ Firm and/ or previous scheme.
- Outline the Fund's accounting policies / internal audit / proprietary or governance audit function, if any. Has there been any major control weaknesses identified from the audits? If so, what is the Firm doing to resolve the identified weaknesses?
- Describe any significant changes in the Firm's Valuation Policy in the previous years.
- Describe any deviations between the Fund's Valuation Policy and established guidelines under law/ regulation and / or the IPEV Valuation Guidelines[116].
- Describe the role of Fund's LP Advisory Board, if any, plays in matters stated above.
- Describe any past criminal or statutory proceedings or investigations / demand notices / show cause or prosecution notices against the Fund/ Firm, its affiliated entities and/ or its current and former Investment Team members. Are there any such on-going proceedings and if so, details thereof.
- Describe any charge / accusation and/ or conviction of fraud or misrepresentation / disciplinary action by a professional body against any of the Fund/ Firm's current or former Investment Team members / associates and external service providers that were engaged in the past or are under current engagement.
- Provide an overview of the third-parties providing services to the Fund / Firm (such as law firms, custodians, consultants, investment banks, marketing associates, distributors, investment advisors etc.). How does the Fund/ Firm manage counterparty risk related to these third party arrangements?
- What types of insurance coverage does the Fund/ Firm maintain (e.g. key man, directors' and officers' insurance etc.)? Does the Fund have a policy to insist on key man and asset insurance to be taken by investee companies?
- Investor Grievance Redressal system as may be required by SEBI, grievance committee, disposal mechanism, conflict resolution mechanism and policy.
- Statement of compliance with SEBI prescribed Compliance Test Report to be filed by the investment manager at the end of every financial year to furnish the details of compliance with AIF Regulations and circulars issued thereunder. Are there any non-compliance issues or observations raised / notices issued by SEBI in this regard? Any proceedings past or present with SEBI / SAT or any orders passed?
- Does the Fund/ Firm have any intellectual property / other registrations? Provide details.

[116]The International Private Equity and Venture Capital Valuation (IPEV Guidelines) issued by the IPEV Board set out recommendations intended to represent current best practices on the valuation of alternative investments. The objective of these Valuation Guidelines is to set out best practices with respect to valuing all debt and equity Investments of investee companies / entities. The emphasis is that they are reported at 'Fair Value' to help investors in AIFs make better economic decisions. The approach of the IPEV Guidelines is described briefly in Section 11.8.1.

- What are the Firm's ESG-related policies and how do ESG factors influence its investment beliefs?

Additional Track Record Information for Debt Funds

- Gross IRR for all the deals with breakup of coupon, redemption premium, equity upside, any other fees, etc.
- Investment structure for all deals.
- Security structure for all the deals: senior/ junior, security cover, cash escrow, NOC requirements, other security components.
- Non-Performing Assets (NPAs): Any delays, defaults in past or the current investments and how are these managed by the fund.
- Original vs actual loan tenure. Details on pre-payments.
- Loan amortization schedule.
- Total debt of the companies with details of other lenders.
- In debt investments, describe a situation in which an investee company or asset has defaulted / filed for bankruptcy or failed to make payments under any secured or unsecured borrowing facility or failed to adhere to debt covenants / creation of security. What debt resolution strategies were considered / adopted in such situations?

Proposed Fund / Scheme Details

- Target size of the fund (availability of any green shoe option)
- Tenure of the fund (and extension)
- Plans for first and final closing
- Any capital already committed to the fund by institutional investors?
- Any investments committed from the fund
- Sponsor and sponsor commitment
- Target returns – hurdle rate, intended returns
- Detail the fundraising timeline, including each of the actual or anticipated closing dates. State the total commitments received to date and, if available, the names, contact details and amounts committed by each investor (differentiating between hard and soft commitments). Describe the provisions regarding the admission of additional investors in subsequent closings after the first closing.
- List any investors in the previous fund that will not participate in the Fund, and provide reasons for their non-participation. List all secondary sales if any, of LP interests in the previous schemes.
- If applicable, provide details for the Fund's investments and deal pipeline to date. If no investments to date, when does the Fund expect to begin investing?
- State the Fund's policy regarding co-investments with other funds, other affiliates and/ or investors. How will these co-investment opportunities be allocated? If applicable, provide examples of past co-investments.

- Indicative drawdown schedule for the investors and in approximately how much time will the fund be fully deployed?

Investment Strategy

- Summarise the Fund's investment strategy and types of transactions the Fund will pursue. Include details on anticipated transaction sizes (including minimum/ maximum), holding periods, geographic focus, industry/ sector focus, investment stage and other relevant characteristics. Are there any sub-sectors identified which will be the key focus areas for the fund?
- Sweet spot of investment size, Total deal size, Stage of the company.
- Discuss the Firm's ability to invest at the Fund's targeted size. Address any significant change in fund size compared to previous funds, and the impact of co-investing.
- Discuss how the Fund's investment strategy compares to the previous fund(s). Is the Firm's/ Fund's investment strategy expected to change in the future?
- How many companies does the fund intend to invest in? What will be the typical first round amount? How much amount is typically kept for follow-ons, what percentage of companies get follow-on rounds?
- Describe the Fund/ Firm's competitive advantages and discuss how the Fund/ Firm attempts to produce replicable returns.
- Any upper limit for exposure to a single company? Or exposure to a sub-sector? And whether it complies with specific requirements of SEBI (AIF) Regulations?
- Describe the Fund's expected investment structures. What will be the typical equity structures used by the Fund? Discuss the policy on use of leverage at the portfolio company level and state the targeted leverage levels (%).
- Describe the Fund/ Firm's preference for being a control, minority, joint or sole investor. Detail this preference historically. What controls and rights does the Fund/ Firm seek when executing investments? If predominately a control investor (buyout Fund), under what scenarios would the Fund/ Firm consider a non-control position (and vice-versa)?
- Discuss the risk factors of the Fund's investment strategy (e.g. political risk, economic, financial, technology, business cycle, etc.) and the steps that would be taken to mitigate these risks.
- Describe (citing examples) the strategies that are used to incentivise portfolio company management teams to reach negotiated milestones.
- Discuss the typical methods used by the Fund/ Firm to create value for its portfolio companies (restructuring, strategic re-positioning, leveraging, operational improvements, etc.). Discuss how the Firm's strengths in creating value for investments impact its sourcing capabilities. Provide case studies to illustrate the Firm's value creation capabilities.
- Exit timelines for the investment? Typical exit strategies and exit rights to be negotiated. Describe the Firm's policy on IPOs as preferred exit. If applicable, include

information about any dedicated internal group/ advisors that monitors the public markets in anticipation of an IPO and associates with the investee company management to prepare the company for an optimal IPO.

- Describe how the Fund/ Firm will ensure to protect against fraud and corruption, post-investment / policy, regulatory, tax and contractual risks / FATCA non-compliance / statutory non-compliance with AIF and other applicable regulations, rules and guidelines / moral hazards and governance risks. Detail out the whistleblower policy to be implemented in investee companies. If applicable, discuss any fraud and/ or corruption that were detected in prior investments and how these were handled.

Investment Process

- Explain the deal flow generation process and the use of external agencies to generate deal flow. How do the investment managers / principals engage in the deal generation process? Describe the robustness and sustainability of the Fund/ Firm's proprietary network of contacts used to identify opportunities.
- Deal flow and filtering metrics – What kind of deal flow does the team get? What % of such deals qualifies for detailed evaluation? What % of deals finally goes through?
- Describe the screening and due diligence processes. How is each process staffed, conducted and documented? Will the deal team be in charge of the investment until exit, or will there be other monitoring and executing teams, post-investment? Include details on any internal due diligence checklists, external due diligence reports, internal reports, financial models and investment committee documents prepared. Is external diligence (financial/ legal/ tax) done in all of the deals?
- Run through an Investment Memorandum prepared for the Investment Committee meetings for any of the past deals to understand the evaluation and recommendation process. Does the team partner with any external experts at the evaluation stage?
- How much time does it usually take to close a transaction?
- What will be the composition of Investment Committee (IC)? What will be the approval process (majority/ consensus)?
- Have there been any deals in the past which went to IC and didn't get approved? What are the deal breakers for any transaction? Are the minutes of IC meetings documented?
- Is a board seat compulsorily taken in all of deals? Discuss the Firm's approach to board representation at its portfolio companies.
- How is the portfolio monitoring done and in what frequency? Is there any help (legal/ financial/HR) provided to portfolio companies by the fund team resources?
- Discuss the Fund/ Firm's portfolio investment monitoring policy, including details about contact events (weekly, quarterly, board meetings, etc.). What information is required to be reported by the portfolio investments?

- How many active portfolio companies is each person in the investment team responsible for? In addition to active investments, how many deals in the pipeline is each team member including partners/ directors responsible for? What is the Fund/ Firm's process for handling bandwidth during periods of peak activity phases?

Investment Team

- Details of the team members and since how long have they been working with each other.
- Any key employees who have left in the past.
- How many company boards is the fund team already a part of? Is there an upper limit to the number of companies one person can be on the board of?
- Back office team and client communication process.
- What is the remuneration and incentive structure? What is the carry split with employees?
- Samples of service contracts, appointment orders.

Documents to be reviewed

- Trust Deed / LLP Deed / Memorandum and Articles of Association
- Investment Management Agreement
- Fund Accountant / Custodian Agreement
- One client Subscription Agreement (can be on a no name basis)
- Sample valuation reports of the portfolio companies
- Annual audited report of the fund
- Sample Reporting documents issued to investors by the Fund / Firm
- Latest Annual Compliance Test Report filed with SEBI
- Sample Investment Memorandum / Proposal note for a deal recommendation to the Investment Committee
- Sample/ copy of Investment Committee minutes, if documented
- Sample external Due Diligence Report for a past investment

Sample Questions: Chapter 8

1. 'Alignment of interests' is required between ___________.

a. the AIF and its auditor

b. the manager and the AIF investors

c. the AIF and the subsidiary

d. the LLP and the trust

2. One of the criteria to evaluate a fund manager is _____________.

a. the economic risk of the investment

b. the timing of the cash flow

c. the prior performance track record of the fund

d. the general investment climate

3. Fund due diligence means _________.

a. the due diligence conducted on the AIF

b. the due diligence made by the manager

c. the due diligence conducted on the investee company

d. the due diligence conducted by the auditor

4. One of the important documents used in fund due diligence is the Private Placement Memorandum (PPM). State whether True or False.

a. True

b. False

5. Key man in the AIF context means a key person or persons involved with the allocation of financial resources to the fund. State whether True or False.

a. True

b. False

CHAPTER 9: LEGAL DOCUMENTATION AND NEGOTIATION – INVESTOR PERSPECTIVE

LEARNING OBJECTIVES:

After studying this chapter, you should know about:

- Various legal documentations in the context of AIFs and their importance
    - Trust Deed/ LLP Deed/ Memorandum and Articles of Association
    - Investment Management Agreement
    - Subscription Agreement and Side Letters
    - Private Placement Memorandum
    - Other Support Services' Agreement

9.1 Introduction

The term 'legal documentation' in the context of an AIF refers to the set of legal contracts and documents that define the AIF architecture and set out the binding roles and performance obligations of the connected parties in such a way that the outcome of the fund activity protects the interests of the investors and other stakeholders. The principal documents to be mentioned in this regard are – (1) the constitutional document of the AIF, (2) the contractual document governing the investment management, (3) the contractual document governing the investors' relationship with the AIF, (4) the Private Placement Memorandum or the PPM and (5) the various service agreements that define the roles and responsibilities of other stakeholders such as trustees, investment advisors etc. and service providers such as distributors.

To attract high quality investors, it is essential that the fund documents (including marketing literature prepared by the Fund and the distributors such as the 'Pitch documents' and the PPM) include an articulation on the fund's governance standards. Fund documents are an important aspect of the fundraising exercise. Fund documents also serve the very important purpose of making the whole fund structure bankable from a regulatory, commercial and contractual perspective so that investors are reassured of the protection of their interests.

9.2 The Trust Document/ Limited Liability Partnership Deed/ Memorandum and Articles of Associations

When the AIF is constituted as a trust, it is necessary to constitute it through a 'Trust Indenture' which is a registered document that is executed between the sponsor and the trustee to bring the trust into existence. This document is registered so as to give it the status of an incorporated juridical person. The sponsor is the settler of the trust who conveys the initial sum of money to the trustee towards setting up the trust and creating its assets. The trust document is also the instrument of trusteeship which is vested in the trustees of the AIF. The trust document has to be drafted carefully to conform to the 'determinate' status of its corpus and is necessary to establish its status and tax treatment with the revenue officials under the Income Tax Act, 1961.

In the case of an LLP structure, the constitutional document would be the LLP agreement signed between the managing partners initially and thereafter it would induct the investors into the partnership. It would define the relationship between the partners and all commercial understanding between them contractually. The LLP is registered with the Registrar of Companies (ROC) to provide it with a legal persona.

If the AIF is constituted as a company, the manager would incorporate it with initial shareholders as subscribers to the Memorandum. The memorandum and articles of association are registered with the ROC and the company takes birth with a distinct legal entity.

The constitution document of the AIF is shared with all investors of the AIF alike, being the charter document, and also shared with SEBI for registering the AIF under the AIF Regulations.

9.3 The Investment Management Agreement

The Investment Management Agreement (IMA) is required to be entered into by and between the trustee (on behalf of the AIF) and the investment manager. This agreement not only sets out the terms of fund management by the manager but in effect, the trustee delegates all its management powers in respect of investment management to the investment manager.

A trust structure permits ring fencing of the manager's liability (including from a fiduciary, breach of fund documents perspective) from that of the AIF's, because the manager is only a counterparty service provider to the AIF, unlike also being on the board of directors of an AIF which could be a company, or being a designated partner of an LLP. It is due to this reason why almost all AIFs in India are constituted as trusts and not as LLPs. There is also no reported case of an AIF in a company structure due to this reason.

Nowadays, investors are becoming increasingly cautious about providing excessive bandwidth to managers in terms of their functioning or commercial interests in the wake of the financial crisis in 2008 and several frauds that surfaced in fund management. There can also be a termination clause in the investment management agreement with the fund / subscription agreement that may provide for termination of services of the manager or withdrawal of the investor in the event if it has come to light that the interests of the investors and manager are grossly mis-aligned and there is a considerable moral hazard in continuance. These aspects need to be looked into carefully in drafting the agreement and provisions made therein for termination of management services.

'***For cause***' removal typically refers to the premature termination of the manager's services to the fund by the investors, owing to events of default – mainly fraud, wilful misconduct, and gross negligence. Since these facts are subject to interpretation by the courts, such litigation could be long drawn and vexatious. Suitable dispute resolution provisions through arbitration could mitigate this risk to some extent.

9.4 The Subscription (Investor Contribution) Agreement

The Contribution Agreement is to be entered into by and between each contributor (i.e. investor), the trustee and the investment manager. This agreement sets out the terms between the AIF and the investor and is amenable for amendments as may be required from time to time. The Contribution Agreement sets out the conditionalities for an investor to participate in the AIF. Considering that most fund investments are about blind pool investing, the subscription agreements includes all aspects relating to fund investing such as computation of beneficial interest, drawdowns, distribution waterfall, commercial aspects of fees and expenses, fund governance structure and so on. The Contribution Agreement for each Contributor is generally not shared with other Contributors, as it contains representations and warranties which may be specific to each Contributor.

In the trust structure, issue of unit certificates representing the unit capital held by an investor is not required but a statement of account needs to be furnished to the investors to show their determinate share in the trust. Such requirement would be specified as part of the subscription agreement. This compliance requirement protects investor interests.

LLPs and companies have specific processes to receive contributions towards capital from their partners, shareholders. LLP provisions are contained in the Limited Liability Partnership Act. In case of a company, share allotment / application money, etc. are regulated concepts, which require compliance with the Companies Act, 2013. Since AIF investment arrangements require more flexibility between the terms governing the investors, AIF and the investment manager, a company structure will pose difficulties to set up an AIF. Hence, a trust structure has become the most popular to constitute an AIF and enter into subscription agreement for investor contributions.

9.4.1 Side Letters with Investors

In many instances, investors may seek specific investment arrangements with respect to their participation in the fund. Since these may not be generic to all investors but may be available only to a few institutional or large investors, they are recorded separately in supplementary documentation known as the side letter(s). These are executed by the specific investor, the AIF and the investment manager. Most of the time, side letters relate to differential terms for charge of management fee, working of the distribution waterfall, participation rights in investment committees, investor giveback, etc. Sometimes, investors may also insist on including a protection right that would protect them from the risk of any other investor being placed in a better position than them. Side letter enforceability has not been tested adequately in Indian courts and they do have certain amount of legal risk for such investors. An investor may also insist on including a 'Most Favoured Nation' (MFN) clause to prevent any other investor being placed in a better position than itself.[117]

However, it is important to note that the investment manager has a fiduciary duty towards other investors in the fund. Hence, the investment manager should ensure that they are not in breach of such fiduciary duty, in an attempt to provide differential rights to some large investors. To avoid such a breach of fiduciary duty, most investment managers create a separate class of units with differential rights, issued to large investors.

In global practice, AIFs may be set up in such a way that the key constitutional and fund terms are included in the charter documents, and only certain specific terms for some investors (which are carefully worded so as not be construed as prejudicial to other investors) are included in side letters. Such charter documents are executed by all investors to the fund, along with the fund and the manager while the side letters are not disclosed to the other investors since they are bilateral between AIF / investment manager and the specific investors. Therefore, only those terms which would only require individual right of action for an investor against the fund or the manager, and not impact the general operations of the fund vis-à-vis other investors, are contained in the side letter(s). Having side letters would generally make the job of an Advisor difficult to assess the risk for his investors, since he is unaware about the preferential rights already granted to the existing investors.

[117]MFN Clause allows an investor to receive side letter entitlements, which can be used to protect themselves from less favourable terms or conditions in the PPM, as compared to the terms or conditions offered to other current or future investors.

9.5 Private Placement Memorandum

Under the AIF Regulations, the Private Placement Memorandum (PPM) should contain all material disclosures about the AIF, such as parties comprising the fund structure (the manager, the key investment team, sponsors and trustees, custodians, bankers, auditors and legal advisors). The other essential details relate to targeted investors, fees and other expenses proposed to be charged from the fund, tenure of the scheme, conditions or limits on redemption, investment strategy, risk factors and mitigation, fund governance structure, conflicts of interest and procedures to identify and address them, performance history of the AIF and the manager, key terms of the investment management services, details of other service providers, process of winding up the scheme and all other information that is considered necessary for investors to take informed investment decisions. Perceiving the need to introduce common disclosure requirements for PPMs issued by AIFs, SEBI issued a circular that provides for a common template of PPM.[118] Annexure 1 to this circular provides the common template of a PPM to be used by Category I and II AIFs. The summary disclosures in the PPM as per this Annexure are listed below in Box 9.1.

Box 9.1: List of Disclosures in a PPM

SECTION – A

Section I: Executive Summary

Brief details of the AIF, scheme, sponsor, manager, affiliate entities if any, investment objective and strategy, allocation of corpus as per investment sector or geography etc., target corpus, classes of unit capital as applicable and basis of classification, terms of the Fund/ Scheme starting from the final closing date, extension applicable, if any, subject to AIF Regulations, minimum capital commitments sought, sponsor / manager commitment, subject to the minimum requirements under the AIF Regulations, commitment period (in number of years or months) including date of commencement and ending of the commitment period, drawdown terms, initial closing, subsequent closings and final closing, proposed management fee details, preferred return (Hurdle rate) as proposed in IRR terms or any other method, additional return or carried interest as proposed, expenses structure, distribution waterfall for each class of units are required to be part of disclosures under this section.

Section II: Market Opportunity/ Indian Economy/ Industry Outlook

- General economic background and data, if any, that the Manager deems to be relevant from the perspective of the Fund/ Scheme with reliable sources cited for

[118] SEBI Circular No.: SEBI/HO/IMD/DF6/CIR/P/2020/24 dated Feb 05, 2020 (issued on SEBI website on Feb 6, 2020) [https://www.sebi.gov.in/legal/circulars/feb-2020/disclosure-standards-for-alternative-investment-funds-aifs-_45919.html]

the data Investment outlook of the Sponsor/ Manager (including macro-economic and micro-economic factors) that may be relevant to the strategy of the Fund/ Scheme.

- Sector/ industry outlook that may be relevant to the strategy of the Fund/ Scheme.
- Any other aspect that the Manager/ Sponsor wishes to highlight in the context of the Fund's/ Scheme's investment strategy.

Additional information on this section may be provided in supplementary section.

Section III: Investment Objective, Strategy and Process

This section will detail the investment strategy with break-down into sectors, geographies, cap on investment in each investee company or sector, break-down of investible corpus for domestic investee companies and overseas companies, prescribed approvals required for change or deviation in investment strategy and any other additional details as may be necessary. A flow chart depicting the investment process in an investee company is also required to be furnished.

Section IV: Fund/ Scheme Structure

This section includes the following:

- A complete diagrammatic representation of the Fund/ Scheme structure disclosing all key constituents (e.g. sponsor, trustee, manager, custodian (if any), investment advisor (if any), offshore feeder (if any), offshore manager (if any), etc., as may be applicable); along with a brief description of the activities of the Fund/ Scheme and its constituents, jurisdictions that may be applicable (if identified), nature of relationship between each constituent of the Fund/ Scheme, as well as classes of units/ interest held by each constituent in the Fund vehicle(s);
- Brief description of the structure of the Fund/ Scheme.

Section V: Governance Structure

It has to talk about the governance structure of the AIF, listing out details of the sponsor, trustee, manager, key investment team in the manager's organisation, investment committee, advisory board, if any, investor advisory committee, if any, investment advisor, if any etc.

Detailed information on the investment team members are also provided, such as qualification, prior work experience of every team members and Terms of reference of the committee constituted for approving the decisions of the Alternative Investment Fund[119]

Section VI: Track Record of Manager

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

The broad points to be included in this regard, for each fund (including schemes of the fund, as applicable) so previously set up (to be depicted in tabular form, with separate tables for separate funds) will be as follows:

- Investment strategy of the fund
- Size of the fund
- Number of investments made by the fund
- Amounts deployed by the fund
- Gross IRR (Internal Rate of Return) for the fund
- Gross MOIC (Multiple on Invested Capital)
- DPI (Distributed to Paid-in)
- RVPI (Residual Value in Multiple)
- TVPI (Total Value to Paid-in)
- Description of portfolio companies and investment exits for the fund

Section VII: Principal Terms of the Fund/ Scheme

This is the longest section in the PPM and discloses, in detail, the items listed out above in the Section I and additional items about the Fund/ Scheme. Distributors need to understand the complete details that would be furnished under this section as it forms the basis for the entire investment paradigm.

Section VIII: Principles of Portfolio Valuation

This section shall broadly lay down the principles that will be used by the Manager for valuation of the portfolio company which could inter alia include:

- Details of the entity to be appointed as the Valuer of the Fund/ Scheme.
- Frequency of valuation of the portfolio companies.
- Valuation principles used by the Fund/ Scheme for valuation of portfolio companies - (whether the Fund/ Scheme follows the International Private Equity and Venture Capital Valuation (IPEV) Guidelines).
- Any other guiding principles relevant for the investors to know with respect to valuation of the Fund/ Scheme.

Section IX: Conflicts of Interest

This section shall lay out, in detail, all potential sources of conflicts of interests that the Manager envisages during the operations of the Fund/ Scheme, which includes conflicts arising at following levels:

- At the level of employee of the management entity
- At the level of service providers of the Fund/ Scheme
- At the level of the Manager
- At the level of the Sponsor
- At the level of the investor

- At the level of members of various governance bodies (as described in section titled "Governance Structure and Investment Process")
- At the level of the Sponsor/ Manager group entity, in relation to various schemes managed by the Sponsor/ Manager.

Section X: Risk factors

This section should lay down as exhaustively as possible. All potential risk factors that the investors need to be aware of in respect of their investments in the Fund/ Scheme. It should tabulate specific risks attributable to specific type of instruments to be invested in by the Fund/ Scheme, i.e. risk specific to debt instruments, equity etc., risk factors specific to certain type of investors in the Fund/ Scheme, for example overseas investors. The broad categories of risk disclosures are the following –

1. Risks related to Portfolio Investments in particular
2. Risks Related to Fund/ Scheme Structure
3. Regulatory Risk Factors
4. General Risk Factors
5. Tax related Factors
6. Specific Risk Factors – related to specific sectors/ strategy that the AIF wishes to invest in
7. Currency Related Risks – including risks related to investing overseas

Section XI: Legal, Regulatory and Tax Considerations

- Indian Trust Act, 1882 / Limited Liability Partnership Act, 2008 / Companies Act, 2013. Details as may be applicable regarding the constitution of the Fund/ Scheme.
- SEBI (Alternative Investment Funds) Regulations, 2012
- Relevant extracts of the SEBI (ICDR) Regulations, 2018 in so far as they relate to initial public offerings (IPOs), Qualified Institutions Placements (QIPs) and Preferential Allotments.
- Relevant provisions of the SEBI (Substantial Acquisition of Shares and Takeovers) Regulations, 2011 ("Takeover Code"), including open offer and disclosure requirements.
- Relevant provisions of the SEBI (Prohibition of Insider Trading) Regulations, 2015.
- Relevant provisions of the Prevention of Money Laundering Act, 2002 (the "PMLA") and rules thereunder, including any amendments thereto.
- General and specific provisions to be highlighted from the Companies Act, 2013 depending on investment strategy/ type of instrument that the Fund/ Scheme seeks to invest in.
- Relevant provisions of FEMA that permit foreign investments into an AIF including conditions under Schedule 8 of Foreign Exchange Management (Non-debt Instruments) Rules, 2019.

- If the AIF is foreign owned or controlled, relevant provisions from extant foreign investment laws as applicable to downstream investments may be provided.
- Other sector specific regulatory disclosures depending upon the sectors that the AIF may be exposed to as per the investment strategy.
- Competition law as may be applicable based on the investment strategy of the Fund/ Scheme to be provided.
- Tax regime as per the provisions of section 10(23FBA), section 10(23FBB), 194LBB and section 115UB of the Income Tax Act, 1961 and any potential risk factors that could be applicable to the Fund/ Scheme.
- Taxation applicability on individual incomes of the AIF
- General Anti Avoidance Rules
- Applicability of Goods and Service Tax Act, 2016.

Section XII: Illustration of Fees, Expenses and Other Charges

This has to be presented in a tabular format showing the total contributions received, the break-up of fees, expenses and other charges that will be charged to the fund and the net deployment of funds by the AIF year on year during its entire life.

Section XIII: Distribution Waterfall

This is also supposed to be presented in tabular form showing scenarios as follows – (a) the fund is at a loss, (b) the fund is at no profit or loss, (c) the fund has earned profits but less than the hurdle rate, (d) the fund has earned profits equal to the hurdle rate and (e) the fund has earned profits in excess of the hurdle rate. The illustrative distributions should also be shown for each class of units separately.

Section XIV: Disciplinary history

Entities against whom the disciplinary history should be provided – Sponsor, Manager, Trustee, Associates of Sponsor, Associates of Manager, Directors/ Partners of Sponsor, Directors/ Partners of Manager and Directors/ Partners of Trustee.

Section XV: Glossary

All terms used in the PPM including industry parlance terms should be explained in this section.

SECTION – B

This section of the PPM accommodates all additional disclosures that the AIF makes over and above the minimum disclosures prescribed in Section A of the PPM. These additional disclosures may refer to some of the individual sections stated above and/ or additional disclosures.

As per the SEBI (AIF) Regulations, the Investment Manager or Sponsor must launch AIF schemes after filing the PPM with SEBI, through a SEBI registered Merchant Banker, at least 30 days prior to launch of scheme, along with payment of scheme fee.[120] However, the application fee is not applicable in case of a launch of the first scheme by AIFs.

The Merchant Banker must exercise independent due diligence of all the disclosures in the PPM, satisfy itself with respect to veracity and adequacy of the disclosures and provide a due diligence certificate on a prescribed format by SEBI.[121] The details of the Merchant Banker shall be disclosed in the PPM. While filing the draft PPM at the time of registration or prior to launch of new scheme, the due diligence certificate provided by the Merchant Banker shall also be submitted, along with other necessary documents.

SEBI may communicate its comments, if any, to the merchant banker prior to launch of the scheme and the merchant banker shall ensure that the comments are incorporated in the placement memorandum prior to launch of the scheme. Further, AIFs are required to intimate SEBI directly or through a Merchant Banker (based on the type of change) regarding any changes in terms of the PPM on a consolidated basis, within 1 month of the end of each financial year.[122]

Due to the specific disclosures prescribed by SEBI, PPMs have the status of regulated documents under the AIF regulations. SEBI scrutinises the PPM to consider the application for registration of a proposed AIF; all investors are expected to have read, understood and agreed to the terms of the PPM before making an investment in the AIF; and any changes to the PPM are matters of investor vote. All changes made to the PPM till the final version must be highlighted in the copy of the final PPM. It may be emphasized that, SEBI provides only observations on the PPM submitted to them and does not approve the document. The below text is generally shared by SEBI with all the AIFs submitting their PPMs:

"*It is to be distinctly understood that submission of the PPM to SEBI should not in any way be deemed or construed that the same has been cleared or approved by SEBI. SEBI does not take any responsibility for the accuracy and correctness of disclosures, facts and claims made in the PPM and the capability and performance of the Manager. It is Manager's responsibility to take all reasonable care to ensure that the information in the PPM is true and accurate in all material respects and in compliance with SEBI (Alternative Investment Funds) Regulations, 2012 and other applicable laws and that there are no material facts, the omission of which would make any statement in this memorandum, whether of fact or opinion, misleading. This*

[120]Not applicable for Large Value Fund of Accredited Investors.

[121]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.

[122] SEBI Circular No.: SEBI/HO/AFD/PoD/CIR/2024/028 dated April 29, 2024 on Relaxation in requirement of intimation of changes in the terms of PPM of AIFs through Merchant Banker.

requirement is to facilitate investors to take an informed decision for making investment in the proposed Fund/Scheme."

9.5.1 Additional Disclosures under PPM[123]

Investor Charter

To facilitate investor awareness, SEBI, in its recent circular, has notified that all registered AIFs are required to bring out Investor Charter providing relevant information about the activities pertaining to the AIF. This Investor Charter is a document with details of services provided to investors, details of grievance redressal mechanism and responsibilities of the investors at one single place, for ease of reference. The Investor Charter to be published in the following manner:

a) For new schemes, the AIF should disclose the Investor Charter in the Private Placement Memorandum (PPM)
b) For existing schemes, the AIF should disclose the Investor Charter to the investors on their registered e-mail ID, as a one-time measure

The Investor Charter provides detailed information on the following: (see *Annexure 9.1*)

- Vision and Mission Statement
- Details of business transacted by the AIF, with respect to the investors
- Details of services provided to investors, as per SEBI (AIF) Regulations, at the time of:
    - On-boarding Investors
    - Obtaining investor consent for material changes to fund structure
    - Disseminating financial information of Fund
    - Providing Disclosures with respect to Material Risks associated with the fund and its portfolio investments.
    - Intimating any non-material changes in the operations of the fund
    - Grievance Redressal
- Timelines of every activity/service provided to investors, in accordance with SEBI (AIF) Regulations, specifically at the time of:
    - Providing Valuation-related disclosures
    - Providing transparency and making important disclosures
    - Handling complaints
- Details of grievance redressal mechanism and how to access it
- Responsibilities of Investors, with respect to:
    a. Informing and Educating themselves
    b. Timely updating the KYC and information required by Intermediaries

[123] Vide SEBI Circular No.: SEBI/HO/IMD-I/DOF9/P/CIR /2021/682 dated December 10, 2021 on Publishing Investor Charter and Disclosure of complaints by AIFs.

c. Abiding by the Contribution Agreement
d. Using services of right financial intermediaries, consultants and advisors
e. Maintaining Confidentiality of Information

Disclosure of Complaints

In addition to the Investor Charter, all registered AIFs are required to disclose the data on investor complaints received against them (AIFs) and each of their schemes; and redressal status thereof in the following manner:

a) For new schemes, the AIF should include a separate chapter on its Investor Grievance Redressal in the Private Placement Memorandum (PPM)
b) For existing schemes, the AIF should update the PPM within one month from end of each financial year and inform the investors and SEBI on a consolidated basis.

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

9.5.2 PPM Audit

In order to ensure compliance with the terms of PPM, it will be mandatory for AIFs to carry out an annual audit of such compliance at the end of each financial year. The audit shall be carried out by either internal or external auditor/ legal professional. However, audit of sections of PPM relating to 'Risk Factors', 'Legal, Regulatory and Tax Considerations' and 'Track Record of First Time Managers' shall be optional. In addition, 'Illustration of Fees and Expenses' and 'Glossary and Terms' shall also be optional.[124]

The findings of the audit, along with corrective steps, if any, shall be communicated to the Trustee or Board or Designated Partners of the AIF, Board of the Manager and SEBI within 6 months from the end of the financial year. The terms of contribution or subscription agreement (by any name as it may be called), shall be aligned with the terms of the PPM and shall not go beyond the terms of the PPM.

[124] SEBI Circular No.: SEBI/HO/AFD/SEC-1/P/CIR/2024/22 dated April 18, 2024 on Standardization of the PPM Audit Report.

The minimum prescribed PPM disclosures as per Section A stated above and audit requirements thereon are not applicable in two situations –

- For angel funds as defined in the AIF Regulations 2012.
- AIFs/ Schemes in which each investor commits to a minimum capital contribution of INR 70 crore (USD 10 million or equivalent, in case of capital commitment in non-INR currency) and also provides a waiver to the fund from the requirement of PPM in the SEBI prescribed template and annual audit of terms of PPM, in the prescribed manner.

In addition to above, the requirement of audit on PPM terms is not applicable to those AIFs which have not raised any money from its investors. In this regard, such AIFs need to provide a Certificate from a Chartered Accountant within 6 months from the end of the financial year.[125]

The scope of such PPM audit would be:

- Review of compliance with the minimum subscription for each class of units
- Implementation of the Investment strategy
- Disclosure of the affiliates and any transactions undertaken with them
- Investment policy of the Category I AIF/ Category II AIF and review of investments undertaken in accordance with the investment policy
- Review of fund flow in purchase and sale of securities on sample basis to ensure compliance with the investment strategy
- Review of the class of units of the Category I AIF/ Category II AIF in existence during the year in accordance with the class of units stated in the PPM
- Review of the capital commitments received and drawdowns made during the year in accordance with the terms of the PPM
- Review of management fees charged for each class of units of the Category I AIF/ Category II AIF
- Review of the distributions and additional return charged to the investors
- Ensure compliance with the disclosures required on the Scheme structure and relevant disclosures on all key constituents of the Category I AIF/ Category II AIF
- Ensure that the Category I AIF/ Category II AIF has policy on the governance framework to check for potential Insider Trading, compliance with Anti-money Laundering norms, potential conflict of interests, among others
- Review the Disclosure and compliance with the list of responsibilities entrusted to Trustee, Sponsor and Manager.

[125] Vide SEBI Circular No.: SEBI/HO/IMD/DF6/CIR/P/2020/99 dated June 12, 2020.

- 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

In order to provide ease of compliance reporting and promote uniform compliance standards, SEBI in consultation with Standard Setting Forum for AIFs (SFA) has prepared a standard reporting format for PPM Audit Report applicable to various categories of AIFs.

9.5.3 Material changes in PPM

The AIF Regulations also provide for a compulsory exit option in case the change to the PPM is a case of a 'material change'.[126] Material changes can alter the investor's decision to remain invested in the fund. Such changes include: (1) change in sponsor / manager (not including internal restructuring within the group), (2) change in control of sponsor / manager, (3) change in fee structure or hurdle rate which may adversely affect investors etc. The implications of material changes in PPM are discussed in detail in section 10.6.

In India, fund managers need to function under the confined framework of the SEBI (AIF) Regulations, the fund documentation and the PPM and any material departures could trigger the exit rights of investors.

Distributors need to be careful during their fund marketing activities that though the PPM is an information memorandum and not a legal agreement, investors are supposed to read, understand, agree and invest upon the terms and conditions mentioned in the PPM. This requirement is extremely important and underscores the spirit and rights of investors under the AIF Regulations. Any deviance therefrom could lead to a right of action for the investor. Distributors need to work closely with fund manager to understand the disclosures and terms in the PPM to avoid the risk of mis-selling and consequent implications thereof.

9.6 Support Services Agreements

Support services consist of several outsourced functions of the AIF administration as well as the offices of the investment manager. The Distributor Agreement is a part of such documentation and has been explained in Chapter 13 in Section 13.3. Other such agencies

[126] Vide SEBI Circular No.: CIR/IMD/DF/14/2014 dated June 19, 2014

include merchant bankers, custodians, legal advisors, auditors, fund accountants, tax consultants, valuation experts, technical experts and so on.

9.6.1 Agreement with Merchant Banker

The appointment of the merchant banker under a suitable agreement with the AIF is an important requirement. Such agreement, inter alia, needs to be drafted to include necessary covenants from both parties. While the AIF covenants shall include disclosure of information by the issuer company according to law and regulation, providing necessary details, documents and records and extending support for the conduct of due diligence by the merchant banker. The merchant banker shall provide covenants with regard to performance of their duties and responsibilities under the appointment in accordance with and in fulfilment of the AIF Regulations. In addition, the agreement shall stipulate the commercial terms for the merchant banker for services rendered and shall have adequate provisions to ensure arm's length distance between the parties. The AIF shall also safeguard its own position vis-à-vis the merchant banker in appointing a merchant banker with proper credentials and track record along with adequate experience in AIF business matters and PPMs. The agreement shall stipulate the scope of work, process for conduct of the due diligence and filing of the report and associated steps to be taken by the merchant banker in a time bound manner to ensure quality of service. Necessary representations and warranties from the merchant banker shall be included in the agreements to this effect.

9.6.2 Agreement with Custodian

In view of the regulatory requirements and significant role of the custodians in compliance, back office support and reporting, the custodial agreements is an important documentation in the constitution of the AIF. The custodian agreement is a legally binding contract entered into between the AIF and its custodian. It shall provide for the role and scope of services of the custodian in compliance with regulatory requirements and shall contain all standard provisions with regard to satisfactory performance by the custodian. It shall also include covenant of mutual obligations and responsibilities of the parties apart from specifying the commercial terms of engagement of the custodian. The Sponsor/Manager needs to appoint custodian for a scheme of an AIF prior to the date of first investment of the scheme.

9.6.3 Agreement with Investment Adviser

In an offshore fund structure, the board or the investment manager of the offshore fund may delegate or seek on-site support for its investment management functions from an on-site investment advisor in India. While the offshore investment manager is responsible to the offshore investors, the local investment advisor provides advice in deal assessment, execution and post-investment management. The Investment Advisory Agreement contains the general terms under which such investment advisor renders advisory functions. In some cases, there could be an offshore advisor coupled with an on-shore sub-advisor depending upon the type of fund and other complexities in its structure, investment strategy or fund management.

Investor Charter for Alternative Investment Funds

A. Vision and Mission Statement:

Vision

To develop the Alternative Investment Fund (AIF) industry on professional and ethical lines and maintain high standards of governance and transparency.

Mission

- Maintain high professional and ethical standards within the AIF industry.
- Comply with all applicable regulations and co-operate with the regulators in all aspects of the AIF activity.
- Act in a fiduciary capacity towards the investors.

B. Details of business transacted by the organization with respect to the investors:

- To raise capital from domestic and global investors.
- To invest in portfolio companies in accordance with investment strategy stated in Fund documents, with an objective to generate positive returns for the stakeholders including investors.
- To distribute returns to the investors as per the fund documents.

C. Details of services provided to investors:

1. **On-boarding of investors.**
   - 1.1 Sharing of Private Placement Memorandum (PPM).
   - 1.2 Account opening with the AIF:
     - -Completing KYC of investors and registration of KYC with KRAs.
     - -Sharing of copies of fund documents with investors.
     - -Entering into contribution agreement with investor.
2. **Obtaining investor consent for material changes to fund structure**
   - 2.1 Change in the sponsor or the manager of the AIF.
   - 2.2 Change in control of the sponsor or the manager of the AIF.
   - 2.3 Material changes to terms of PPM
     - -Term of Fund.
     - -Investment Strategy.
     - -Increase in fees and charges.
   - 2.4 Winding up of Fund/ Scheme prior to expiry of tenure.
3. **Dissemination of financial information of Fund.**

3.1 Net Asset Value of Fund/ Scheme.

3.2 Financial information of investee companies.

3.3 Information on performance of scheme/fund.

4. **Disclosures with respect to material risks associated with the fund and its portfolio investments.**

4.1 Any inquiries/ legal actions by legal or regulatory bodies in any jurisdiction.

4.2 Any material liability arising during the tenure of the fund.

4.3 Any breach of a provision of the PPM or any other agreement made with the investor or any other fund documents.

4.4 Intimation regarding any conflict of interest.

4.5 Risks associated with the portfolio, such as concentration risk, foreign exchange risk, leverage risk, realization risk, strategy risk, reputation risk, extra-financial risks such as social and corporate governance risks etc. at fund and investee company level.

5. **Intimation of any non-material changes in the operations of the fund.**

5.1 Non-material changes such as

-Bank account details

-Address of AIF or its Manager or Sponsor

-Contact details such as email-id, contact number, etc. of AIF or its Manager or Sponsor

6. **Grievance redressal**

6.1 Redressal of investor complaints received directly from investors and/ or from SEBI/ SCORES.

D. **<u>Timelines of the activity/ services provided to investors:</u>**

Sl. No.	**Description of activity/ services provided by AIFs to its investors**	**Timeline for completion of activity**
1.	**Valuation related disclosures:**	
a.	Valuation of investment by Category I and II Alternative Investment Fund	At least once every 6 months. Can be extended to once a year with approval of 75% of its investors by value of investment.
b.	Disclosure of NAV of scheme(s) of the Category III Alternative Investment Fund	Close ended fund - quarterly basis

Sl. No.	Description of activity/ services provided by AIFs to its investors	Timeline for completion of activity
		Open ended fund - monthly basis
2.	**Transparency related disclosures:**	
a.	Disclosure of financial information of investee Companies	Category I and II – within 180 days from the year end or earlier as per the fund documents. • Category III – within 60 days from the end of the quarter end or earlier as per the fund documents.
b.	Disclosure of Material risks: concentration risk, foreign exchange risk at fund level and leverage risk, realization risk, strategy risk, reputation risk at investee company level, extra-financial risks such as social and corporate governance risks etc. at fund and investee company level	
c.	Financial, risk management, operational, portfolio, and transactional information regarding fund investments	To be disclosed periodically to the investors
d.	Any fees ascribed to the Manager or Sponsor; and any fees charged to the Alternative Investment Fund or any investee company	
e.	Any inquiries/ legal actions by legal or regulatory bodies in any jurisdiction	As and when occurred
f.	Any material liability arising during the Alternative Investment Fund's tenure	
g.	Any breach of a provision of the placement memorandum or agreement made with the investor or any other fund documents	
h.	Intimation regarding conflict of interest in any transaction	As and when they arise or seem likely to arise

Sl. No.	Description of activity/ services provided by AIFs to its investors	Timeline for completion of activity
i.	Any change in terms of Private Placement Memorandum/ fund documents	On consolidated basis within 1 month of end of each financial year
3.	**Complaint handling related services:**	
a.	Response to complaint received from investors	Within 30 days from the date of receipt of complaint
b.	Redressal of investor complaint received from SEBI/ SCORES	Within 21 calendar days from the date of receipt of complaint

E. <u>Details of grievance redressal mechanism and how to access it</u>

1. Alternative Investment Funds are required to redress all investor complaints in timely manner.
2. An Alternative Investment Fund, by itself or through the Manager or Sponsor, are required to lay down procedure for resolution of disputes between the investors and AIF or Manager or Sponsor through arbitration or any such mechanism as mutually decided between the investors and the Alternative Investment Fund.
3. Investors can also approach SEBI for redressal of their complaints through SEBI SCORES platform. On receipt of complaints SEBI takes up the matter with the concerned AIF.
4. Investors may send their complaints to: Office of Investor Assistance and Education, Securities and Exchange Board of India, SEBI Bhavan. Plot No. C4-A, 'G' Block, Bandra-Kurla Complex, Bandra (E), Mumbai - 400 051.

F. <u>Responsibilities of investors</u>

1. Responsibility to inform and educate yourself

1.1 Read thoroughly all fund documents including Private Placement Memorandum, Contribution Agreement, sales literature, newsletters and understand the product.

1.2 Carefully consider all investment risks, fees, and/or other factors detailed in these documents.

1.3 Ensure and make certain that the proposed investment in the Fund meets your investment objective and is in alignment with your risk appetite.

1.4 Review your portfolio holdings, account statements and transaction confirmation on regular basis to ensure that you aware of all transactions and securities where you are invested.

2. Responsibility to timely update your KYC and information with the Intermediary

2.1 Provide complete and accurate information in your KYC documents, including financial/ income status.

2.2 Timely updation of KYC information.

3. Responsibility to abide by the contribution agreement.

3.1 The investor needs to read carefully and understand the agreement that he/she is entering into with the Alternative Investment Fund and abide by the terms thereof.

3.2 The investor should be aware that investment terms are not guarantee of future performance or returns of the Fund/ Scheme.

4. Responsibility to use right financial intermediaries, consultants and advisors.

4.1 Carefully consider validity and reliability of investment information obtained from all sources, especially unsolicited information obtained over the Internet.

5. Responsibility to maintain confidentiality of information.

Investors shall not disclose any material non-public information that is received by virtue of being investors of the fund, except as may be guided by the terms of the fund documents.

Sample Questions: Chapter 9

1. One of the key disclosures in a PPM is:

a. the amount of investment made by the investor

b. the management fee structure

c. the details of asset securities

d. the minimum guaranteed return

2. Investment objective of the fund refers to ____________.

a. reporting requirements

b. Target TVPI

c. investee company performance

d. identification of investment opportunities

3. One of the following is a key risk factor for an AIF investor:

a. Regulatory risk of the AIF industry

b. Demand-supply gap

c. Personal tax structure of the investor

d. Data privacy of the sponsor

4. Minimum PPM disclosure standards prescribed by SEBI are not applicable to angel funds. State whether True or False.

a. True

b. False

5. SEBI has prescribed minimum disclosure standards for a PPM to ensure guaranteed return by all AIF funds. State whether True or False.

a. True

b. False

LEARNING OBJECTIVES:

After studying this chapter, you should know about:

- Importance of fund performance monitoring and reporting
- Regulatory framework for fund monitoring and reporting
- Various exit strategies adopted by AIFs
- Winding up procedures of an AIF

10.1 Monitoring Alternative Investment Fund Progress and Performance

Considering the basic nature of alternative investments (long-term and illiquid), investors may assume that there is little to be done during the fund cycle once the due diligence process has been completed and the commitment to the fund has been made. This is far from the truth. Ongoing fund monitoring throughout its life cycle is a necessary control mechanism. While investment managers perform their duty of maximising returns at fund level by regularly making, monitoring, nurturing and exiting underlying investments, it is necessary for them to report the fund performance on an on-going basis to investors. On their part investors have to go through the performance reports regularly and ensure that their interests are being served taking corrective action wherever necessary through regular engagement with the managers and the fund governance mechanism.

10.2 Regulatory Framework for Fund Monitoring and Reporting

Under Regulation 20(1) of the AIF Regulations, there is a general responsibility that the AIF shall review policies and procedures, and their implementation, on a regular basis, or as a result of business developments, to ensure their continued appropriateness. This would mean that investment managers as well as investors need to engage on a regular basis to monitor the fund's policies and performance.

10.2.1 Specific Transparency and Periodic Disclosure Requirements

Under Regulation 22 of the AIF Regulations, all AIFs shall ensure transparency and disclosure of information to investors on the following:

a) financial, risk management, operational, portfolio, and transactional information regarding fund investments shall be disclosed periodically to the investors;

b) any fees ascribed to the Manager or Sponsor; and any fees charged to the AIF or any investee company by an associate of the Manager or Sponsor shall be disclosed periodically to the investors;
c) any inquiries/ legal actions by legal or regulatory bodies in any jurisdiction, as and when occurred;
d) any material liability arising during the AIF's tenure shall be disclosed, as and when occurred;
e) any breach of a provision of the placement memorandum or agreement made with the investor or any other fund documents, if any, as and when occurred;
f) change in control of the Sponsor or Manager or Investee Company.
g) AIF shall provide at least on an annual basis, within 180 days from the year end, reports to investors including the following information, as may be applicable to the AIF –
   A. Financial information of investee companies.
   B. Material risks and how they are managed which may include:
      i. concentration risk at fund level;
      ii. foreign exchange risk at fund level;
      iii. leverage risk at fund and investee company levels;
      iv. realisation risk (i.e. change in exit environment) at fund and investee company levels;
      v. strategy risk (i.e. change in or divergence from business strategy) at investee company level;
      vi. reputation risk at investee company level;
      vii. extra financial risks, including environmental, social and corporate governance risks, at fund and investee company level.
h) any significant change in the key investment team shall be intimated to all investors;
i) AIFs shall provide, when required by SEBI, information for systemic risk[127] purposes (including the identification, analysis and mitigation of systemic risks).

10.2.2 Maintenance of Records

Under Regulation 27 of the AIF Regulations, the Manager or Sponsor shall maintain the following records:

(a) the assets under the scheme/ fund;
(b) valuation policies and practices;
(c) investment strategies;

[127] Systemic risk refers to business practices that may lead to a wider financial risk for an AIF much beyond a particular investment risk. For e.g. if an AIF is heavily invested in a particular sector and there are sectoral issues, a larger part of the AIF portfolio may face a risk of erosion in value.

(d) particulars of investors and their contribution;
(e) rationale for investments made.

All the above records are required to be maintained for a period of five years after the winding up of the fund.

10.2.3 Submission of reports to SEBI

Regulation 28 states that SEBI may at any time call upon the AIF to file such reports, as it may desire, with respect to the activities carried on by the AIF. In furtherance to the regulations, SEBI has prescribed through its various circulars the reporting formats for AIFs on an on-going basis to provide for necessary disclosures mentioned in the preceding paragraphs. All AIFs shall submit report on their activity as an AIF to SEBI on quarterly basis within 15 calendar days from the end of each quarter in the revised format.[128] These reports are to be submitted online through SEBI Intermediary Portal.

In addition to the above report, all AIFs are required to intimate SEBI and investors about any changes in terms of PPM and other fund documents. These changes are to be reported on a consolidated manner within 1 month of the end of each financial year.

10.3 Context and Scope of Effective Fund Monitoring

Fund monitoring should be seen as part of a larger control system within the investment process. Investors need to keep their involvement active during fund cycle so as to steer the course of fund management by the manager in their best interests. The information asymmetry and moral hazard related problems can be lessened through effective monitoring. Because of the illiquidity of an AIF, the investor's ability to react to different situations is somewhat limited. In complex problems, a solution will require finding a consensus with the fund manager and the other co-investors, or building alliances with co-investors to exercise pressure and act jointly. This explains why fund due diligence by investors should focus not only on the fund manager but also on the co-investors. There are other benefits of fund monitoring as well. In the context of a co-investment strategy, monitoring is important for screening interesting investment opportunities that may arise. Lessons learned from monitoring can also be applied in the future to improve the due diligence process and the selection of future investments. So focus should be both on acting on standardised formal reporting information received from the fund as well as on informal interactions with the fund managers, co-investors and board of directors of the fund.

[128] SEBI Circular No. SEBI/HO/IMD/IMD-I/DOF6/CIR/2021/549 dated April 07, 2021 and SEBI Circular No.: SEBI/HO/AFD/SEC-1/P/CIR/2023/0155 dated September 14, 2023 on Regulatory Reporting by AIFs.

Generally speaking, investing in and monitoring AIF investments involve more effort and higher costs relative to on-market investment funds. Therefore, fund monitoring and intervention needs to be channelled effectively to realise the benefits appropriately. While monitoring is necessary, excessive monitoring can be counter-productive. AIF investors need to be patient and understanding especially during the early years of a fund's lifetime. By the same logic, investors' reaction should not be typically too little, too late, when things need to be addressed urgently to prevent further deterioration of the fund's outcome.

Fund monitoring is an integral part of ensuring compliance with fund objectives, the terms of the contribution agreement and for gathering information. Fund monitoring should not be confused with fund management, an activity in which, in accordance with the contribution agreement, the investors have no involvement. Fund monitoring is an oversight process on overall asset allocation, portfolio composition, fund governance and performance. Investors have to also keep track of internal and external risk factors that may have a bearing on the AIF's working and outcome. Since investors cannot withdraw from an AIF easily and without adverse outcome, through effective monitoring activities, they may be able to identify and reduce downside risks in time either through a restructuring or by selling the position on the secondary market.

This is especially applicable in the context of a style drift in the investment strategy of the fund. Because of the blind-pool nature of AIF investing, it is crucial for investors to set the risk profile of their investment at the time of commitment. Moreover, given AIF's lack of liquidity, the investor cannot easily adjust portfolio holdings or rebalance them if the manager undertakes actions that are inconsistent with fund documentation. That said, there are risks associated with adhering too closely to a declared investment strategy, especially when market conditions change significantly, creating new opportunities. Investors need to keep this aspect in mind as well.

10.4 Fund Reporting

Generally, fund reporting templates cover the following aspects of fund performance –

- Economy specific details (macro level) – parameters such as GDP growth, fiscal position, currency rate and interest rate outlook and macro stability.
- Sector specific discussion (micro level, trends etc.) – Brief business performance and outlook of each industry that the AIF is invested into.
- Specific details of deals executed by the fund – Transactions that the fund may have executed during the period of reporting. Transactions may relate to new investments, follow-on investments, debt financing, exits and liquidation of investments.
- Current investment portfolio and investment allocation by the Fund – This is a snapshot of the entire portfolio of the fund or specific scheme at the time

of reporting providing break up of funds invested in each company, sector in percentage terms.

- Growth and performance of investee companies and significant developments in the portfolio – A brief profile of each investee company and its progress, new developments in their business, emerging opportunities for the fund in such companies, growth in portfolio value etc.
- Future outlook and deal pipeline during the investing period – If the fund is in the investment phase, the deals in the pipeline including term sheets that may have been signed. Deal discussions in process may also be mentioned if significant progress has been made.
- Exits and exit performance in maturity years – Vintage funds are those that have completed investments and mature funds are closer to harvesting their portfolio and completing their fund cycle. Therefore, exit prospects and execution become very important disclosures. Such funds have to report exit prospects from their portfolio companies providing details of return generation on completed exits.
- Changes to the PPM: All changes in terms of the PPM and in the documents of the Category I AIFs and Category II AIFs shall be intimated to its investors and SEBI on a consolidated basis, within 1 month of the end of each financial year. The intimation shall specifically mention the changes carried-out in the PPM and the documents of the Category I AIFs and Category II AIFs, along-with the relevant pages of revised sections/clauses.
- Investor Charter and Investor Grievance Redressal Mechanism: Category I AIFs and Category II AIFs are required to bring an Investor Charter to the notice of their investors, in the manner prescribed by SEBI, in order to provide relevant information about the activities pertaining to AIF. This Investor Charter is a document with details of services provided to investors, details of grievance redressal mechanism and responsibilities of the investors at one single place, for ease of reference.

Fund valuation and fund performance are reported in the annual statutory reporting by the AIFs. Annual reporting also includes sections on discharge of Stewardship Responsibilities by the fund managers.[129]

Several AIFs operating in India are gradually falling in line with reporting standards prevalent overseas in terms of international practices as per Global Investment Performance Standards (GIPS) by CFA Institute, Institutional Limited Partners Association (ILPA), the International Private Equity and Venture Capital (IPEV) Valuation Board, or the European Private Equity and Venture Capital Association (EVCA) standard practices.

[129]Additional discussion on this aspect is provided in Section 7.6.1

10.5 Conflicts and Concerns in Fund Reporting

Managers may be reluctant to disclose all information to investors and with good reason. Their dilemma is obvious - on the one hand, there is a statutory obligation to disclose information to establish good standards and maintain investor relationship; but on the other hand, further information, especially at a level of detail that allows an independent risk assessment, may potentially impact follow-on fund raising if the fund performance is not progressing well. There is also a rationale for maintaining confidentiality to ensure portfolio companies are protected by data privacy. Managers may be apprehensive that too much information given out could dilute the competitive edge of their portfolio companies or potential deals in the pipeline. In an extreme eventuality, there could be legal complications arising from leakage of proprietary fund information as well.

10.6 Exit Options due to Material Changes in PPM

In situations when an investor may find the investment manager to be incompatible, one of the options is to withdraw from a follow-on fund commitment. This is also most feared by fund managers, as often the loss of a reputable investor sends a clear negative signal to the market.

Fund documentation albeit sacrosanct for compliance during the life cycle of the fund, is however not written in stone. Some of the commercial terms and even the objectives of the fund may be modified if it becomes clear that the original investment strategy cannot be successfully implemented. The AIF Regulations prescribe that when a fund changes its investment objectives, it needs to inform SEBI and its investors about it. Similarly, investors can influence the fund manager to reduce management fees or even release some of the investor commitments. More often than not, managers may reduce the target fund size. In extreme situations, the investment management agreement may be terminated by invoking termination rights. However, investors should avoid defaulting on their commitments as it constitutes a contractual breach of the subscription agreement.

The process of intimation of material changes that may have a significant bearing on the continuance of investors in the scheme / fund shall be dealt with as provided by SEBI in its circulars[130] which is summarised below.

Material changes significantly influencing the decision of the investor to continue to be invested in the AIF. Material changes may be construed as changes in the fundamental attributes of the fund/scheme. They shall include, but not be limited to the following –

[130]SEBI Circular No. CIR/IMD/DF/14/2014 dated July 29, 2014 further clarified through Circular No. CIR/IMD/DF/16/2014 dated July 18, 2014

- Change in sponsor/manager *(not including an internal restructuring within the group)*
- Change in control of sponsor/manager
- Change in fee structure or hurdle rate which may result in higher fees being charged to the unit holders.

In such cases of material changes, the following process prescribed by SEBI has to be followed by AIFs that are close ended. However, such exit process shall not apply in cases where the AIF has obtained the approval of not less than 75% of unit holders by value of their investment in the AIF.

The prescribed exit process is discussed below:

Existing unit holders who do not wish to continue post the change shall be provided an exit option. The unit holders shall be provided not less than one month for expressing their dissent.

In case the scheme of the AIF is close-ended, the exit option may be provided as under:

- The exit option shall be provided by buying out of units of the dissenting investors by the manager/ any other person as may be arranged by manager.
- Prior to buying out of such units, valuation of the units shall be undertaken by 2 independent valuers and the exit shall be at value not less than average of the two valuations.
- The responsibility to provide exit to the dissenting investors shall be on the manager. The expenses for the entire process shall be borne by the manager/ sponsor/ proposed new manager or sponsor and shall not be charged to the unit holders.
- The entire process of exit to dissenting investors shall be completed within 3 months from the date of expiry of last date of the offer for dissent.

The trustee of AIF (in case AIF is a trust)/ sponsor (in case of any other AIF) shall be responsible for overseeing the process, ensuring compliance and regularly updating SEBI on the developments.

10.7 Secondary Exits (Secondaries)

Secondary exit of investor interest would constitute sale of existing unit capital / partnership interests held by the investor to other co-investors in the fund or outside investors at an agreed value. This transaction is known as 'secondaries'. Secondaries are complex to execute from an AIF perspective since these are close ended and illiquid interests. Usually, if there are outstanding commitments of the exiting investor, these are transferred to the in-coming investor along with the existing unit capital.

Secondaries also need to address complexities in fund documentation. The terms of the contribution agreement need to be examined to ascertain the possibility; consents required from other co-investors or the manager and associated issues. The other complication that could arise is in the area of valuation of secondaries. Since fund interests are based on valuation of unrealised investments in underlying portfolio of illiquid investments, arriving at an agreed valuation is a complex exercise. Secondary transactions take place at a negotiated price, often at a substantial discount to net asset value (NAV). In the Indian context, secondaries are yet to evolve into an organised market in the AIF ecosystem.

10.8 Exits from Portfolio Companies

On an average, AIF investment horizon in portfolio companies could range from 3 years to 7 years or slightly more depending upon the category of AIF, maturity profile of the fund cycle and market conditions. The AIFs need to sell out even if they see further appreciation in value if they are in the winding down phase of the scheme / fund. Of course, fund life may be extended for upto 2 years subject to approval by two-thirds of the investors by value of their investment in the fund. Further, with approval of at least 75 percent of the investors by value of their investment in the scheme, AIF may launch a liquidation scheme for liquidating the investments or choose in-specie distribution of the unliquidated investments of an AIF or enter into dissolution period. In absence of consent from unit holders for availing the above options, such investments of the scheme are dealt in a manner prescribed by SEBI from time to time.[131]

The exit strategy from a portfolio company is a long-drawn and complex process and the investment managers have to develop the strategy very carefully for each of the fund investments. In general, the exit options comprise the following routes –

- **Offer for Sale through an Initial Public Offer (IPO)** – This exit is by and large considered the most preferred and attractive exit option for an equity-oriented AIF and has historically yielded the best returns. The AIF makes an offer for sale (secondary share sale) of its holdings in the company in the IPO market thereby encashing its investment at the IPO offer price. In the event the AIF has not entered its winding up phase, it may opt for a partial exit through the IPO and plan for a gradual complete exit through the secondary market post-listing of the stock. This can happen when their fund cycle is on-going and the fund manager is in a position to wait for a better exit prices in the secondary market. IPOs are long drawn and market-sensitive transactions that require advance planning, timing and execution expertise. The investment manager has to engage with the company, controlling

[131] Vide SEBI (AIF) (Second Amendment) Regulations, 2023 w.e.f. June 15, 2023 and SEBI (AIF) (Second Amendment) Regulations, 2024 w.e.f. April 25, 2024.

shareholders or promoters and investment bankers to execute the strategy successfully.

- **Secondary Sale (Trade Sale)** – Under this exit option, the investor exits through a secondary stake sale to a third party. The third party could be another AIF which takes over the selling AIF and assumes its position in the portfolio company. This transaction is thus known as 'trade sale' or 'secondary sale'. In a secondary sale, it is customary to find a VC fund being taken over by a later stage PE fund or an earlier PE being taken over by a later PE investor. This transaction is appropriate when the IPO option is not feasible due to adverse market conditions and the AIF wishes to exit the company due to the completion of its investment horizon.

- **Strategic Sale (M&A Exit)** – This option is similar to the secondary sale option except that in this case, the buyer is a corporate buyer either in the same industry (as a competitor) as that of the portfolio company, or a larger company looking for an entry into that industry. Strategic buyers usually acquire stakes of existing shareholders or sometimes the entire company as part of a business acquisition or for other strategic purposes. M&A exits could provide substantial strategic premium to the sellers depending upon the extent of stake being sold and the status of the investee company in the given industry. This exit is usually the second most preferred exit option after the IPO exit option.

- **Corporate / Promoter Buy back** – A buyback happens when the AIF exercises a 'put option'[132] on the shares being held by it in the investee company. The buyback can be made by the company or the promoters depending upon whom the put option is exercisable on. Buyback by the investee company works well in the AIF context of dealing with unlisted companies since listed companies have a lot more regulatory hurdles in such a process. Even in the case of unlisted companies, there are provisions of law that need to be complied with. Buyback by promoters warrants huge personal / affiliate resources of the promoters to be used in the process. In many AIF backed companies, promoters are not resourceful enough for honouring a put option on them. Furthermore, AIFs usually stipulate a stiff put option exit price for a buyback to compensate for their loss of an IPO exit opportunity. Put options price determination is usually specified as a formula in the definitive agreements so as to avoid ambiguity at the time of the transaction. In large cases, put prices guarantees a certain return or IRR to the investor in the said company as agreed upon earlier. The promoters may stipulate that the 'put' shall be a residual option not exercisable unless the company does not go public within an agreed time frame or

[132] 'Put Option' is a contractual right that may be available by specific terms of an investment agreement. Under this arrangement, the buyer of a security shall have the right (but not the obligation) to sell the security back to the seller as per the terms of the agreement.

the AIF could not avail of other exit mechanism stated above. These are the reasons why a buyback option may not be a feasible option in every case. It is usually used as a last resort in a going concern context.

- **Corporate Liquidation**– This is the least preferred and worst case exit option. Liquidations are statutory processes that take a long time to completion and would only provide salvage value if any, to the AIF. In most liquidation situations, the investee company would have become bankrupt and liquidation is only a statutory mechanism to dissolve the company. Normally a 'liquidation preference' right could exist to protect the AIF's first right of exit if the shares in question are preference shares. Usually a liquidation preference clause might state that the AIF has a right to recover the invested amount along with accumulated dividends in preference to other shareholders. Sometimes, it may provide for 1.5x or 2x right of preference meaning that in the distribution of the liquidation proceeds, the AIF should be given twice its investment before any surplus can be distributed to other shareholders. A third way could be to provide a right to participate in the surplus remaining after taking out their money. Some AIFs decide to protect their right of first exit on liquidation by keeping the investment as venture debt which has priority over equity.

- **Pure Debt Fund Exits**– Pure debt AIFs take the position of secured / sub-ordinate secured / unsecured creditors in investee companies. Their exits are protected by the debt covenants in their investment agreements that provide for periodic servicing of the debt from the operating cash flow of the company. Such covenants may also include other protections such as charge on assets of the company, collaterals and other credit enhancements. All these arrangements are designed to return the debt capital along with the stipulated return. In some situations, the debt could have a convertibility option that would enable the debt financing to be converted into equity. Thereafter the investment would be exited as explained in the equity exit options stated above. The last resort for a debt investor would be forced seizure of assets as per the powers vested with the trustee, liquidation of the company or reference to the National Company Law Tribunal (NCLT) under the Insolvency and Bankruptcy Code (IBC) 2016 to force a sale of the company / assets to realise its dues. All these options require going through a judicial process and could be time-consuming. They also may not realise the dues to the AIF as per their book value. In such a case, the AIF incurs a loss and has to write-off the unrecoverable portion of its debt financing to the portfolio company.

10.9 Winding Up of an AIF

Category I and II AIFs are constituted as close ended funds and therefore require to be wound up at the end of the fund cycle or completion of the tenure of the scheme in order to make terminal distributions to the investors. Regulation 29 of the AIF Regulations provides that an AIF shall be wound up in accordance with the provisions of the statute under which it has been constituted under the following circumstances –

- when the tenure of the AIF or all schemes launched by the AIF, as mentioned in the PPM is over; or
- if it is the opinion of the trustees or the trustee company, as the case may be, that the AIF be wound up in the interests of investors in the units; or
- if 75% of the investors by value of their investment in the AIF pass a resolution at a meeting of unitholders that the AIF be wound up; or
- If SEBI so directs in the interests of investors.

The trustees or the Board of Directors or designated partners of the AIF as the case maybe, shall intimate SEBI and the investors of the circumstances leading to the winding up of the AIF. On and from the date of such intimation, no further investments shall be made on behalf of the AIF.

Within the liquidation period, the assets shall be liquidated, and the proceeds accruing to investors in the AIF shall be distributed to them after satisfying all liabilities. Subject to the provisions of the fund documentation and the PPM, *in specie* distribution of assets of the AIF is also permitted at any time during the life cycle or at the time of winding up as per the preference of investors.

Further, after obtaining approval of at least 75% of the investors by value of their investment in the AIF, during liquidation period of a scheme, an AIF may distribute its investment of the scheme which are not sold due to lack of liquidity, in specie to the investors or enter into dissolution period. In absence of consent from investors, such investments are dealt in a manner prescribed by SEBI from time to time. If unliquidated investments of the scheme are not sold by the expiry of the dissolution period, such investments are mandatorily distributed in-specie to the investors as per the manner specified by SEBI. Upon winding up of the AIF, the certificate of registration shall be surrendered to SEBI and is extinguished.

10.10 Liquidation Scheme[133]

Liquidation Scheme means a close-ended AIF scheme launched only for the purpose of liquidating the unliquidated investments in its existing AIF schemes, whose tenure has expired. These schemes contain the words 'Liquidation Scheme' in its name.

The functions of a liquidation scheme are as follows:

[133] 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.

- The tenure of a liquidation scheme is determined at the time of filing PPM with SEBI.
- The tenure of a liquidation scheme cannot be extended.
- Liquidation scheme does not accept any fresh commitment from any investor and does not make any new investment.

10.11 Dissolution Period[134]

Dissolution Period means the period following the expiry of the liquidation period of the scheme for the purpose of liquidating the unliquidated investments of the scheme of the AIF. A scheme shall enter a dissolution period only after receiving requisite consent from the existing investors.

Before seeking consent from investors for entering the dissolution period, the AIF needs to disclose the proposed tenure of the dissolution period, details of unliquidated investments, valuation of unliquidated investments carried out by 2 independent valuers etc. However, if the scheme of AIF fails to sell the unliquidated investments during the dissolution period such investments shall be mandatorily distributed in specie to the investors. No further extension or liquidation period is available to these schemes after the expiry of dissolution period.

[134] SEBI Circular No.: SEBI/HO/AFD/PoD1/CIR/2024/026 dated April 26, 2024 on Flexibility to AIFs and their investors to deal with unliquidated investments of their schemes.

Sample Questions: Chapter 10

1. Under the SEBI (AIF) Regulations 2012, annual reporting by an AIF to investors shall be:

a. towards the end of the fund tenure

b. after the final close

c. within 180 days from the close of the financial year

d. within 90 days after the balance sheet date

2. The fund has to maintain records relating to ________.

a. all material contracts of investee companies

b. valuation policies and practices

c. monetary policy prescribed by RBI

d. effective rate of return

3. Fund activity reporting to SEBI under the AIF Regulations shall be on a ________.

a. monthly basis

b. annual basis

c. quarterly basis

d. six-monthly basis

4. Any change in the board of directors of an investee company has to be reported by the manager to AIF investors under the reporting requirements. State whether True or False.

a. True

b. False

5. Fund documents once signed cannot be amended during the life of the AIF vehicle. State whether True or False.

a. True

b. False

LEARNING OBJECTIVES:

After studying this chapter, you should know about:

- Basics of valuation of fixed income instruments
- Various approaches to equity valuation
- Various approaches to business valuation
- Different techniques of valuation (Asset based valuation, Discounted cash flow valuation and Relative valuation)
- Valuation of AIF portfolio investments (Valuation Guidelines by IPEV)
- General approaches to fund valuation and regulations thereof
- Role of Valuers and limitations of valuation

11.1 Introduction

Valuation of assets and businesses is an essential element of financial investments in businesses, financial markets and more specifically, in alternative investments. Financial theory devotes a significant part to understanding the approaches and various methodologies to valuation. Though there are several approaches, the most acceptable by theoretical standards is the one that estimates the value of an asset as the present value of its future cash flows. In theory therefore, the value of any financial investment is the Net Present Value (NPV) of its future cash flows i.e., Σ = *NPV.* This method is also known as the 'Discounted Cash Flow' or the DCF method of valuation. Under this method, the value of an asset is represented as –

$$\text{Value of Asset} = \frac{\text{Future Cash Flow}}{(1 + r)^n} \quad \text{wherein } (1+r)^n \text{ represents the applicable discounting factor.}$$

Though the DCF appears to be a straight forward calculation, it is fraught with difficulty. The calculation is also extremely sensitive to the timing of any cash flow. The difference between receiving a cash flow at the start or the end of the year has material impact on NPV. There are others such as asset based valuation, relative valuation and market based valuation but these approaches are used more to corroborate the fundamental value derived from cash flow based valuation. The summarised elements of these discussions are provided in this Chapter.

11.2 Valuation Basics for Fixed Income Instruments

Fixed income instruments (debt securities) are the easier part of a valuation exercise as they provide predictable returns. Fixed income valuation is applicable in an AIF context for three reasons –

a) AIFs that are floated as debt funds could invest in debt securities of investee companies and other entities such as SPVs, InvITS and REITs.
b) AIFs use debt structures in financing investee companies either as a complementary structure to equity financing or as convertibles that would become equity after set milestones are reached.
c) AIFs may also invest in debt securities in the listed or unlisted space to manage risk profile and liquidity of the scheme / fund.

The value of a fixed income bearing instrument such as a bond or a debenture with periodic interest payments can be represented as –

$$\textbf{Value = I (PVA}_{(r,n)}\textbf{) + F (PV}_{(r,n)}\textbf{)}$$

Where I is the annual interest payable on the bond, F is the principal amount (par value) of the bond, r is the required return on the bond, and n is the maturity period.

Illustration 11.1

A INR 100 par value bond, bearing a coupon rate of 12 percent will mature after 8 years. The required rate of return on this bond is 14 percent. What is the value of this bond?

Since the annual interest payment will be INR 12 for 8 years, and the principal repayment will be INR 100 at the end of 8 years, the value of the bond will be:[135]

$$V = \text{INR } 12 \,(\text{PVA}_{14\%,8\text{ yrs}}) + \text{INR } 100 \,(\text{PV}_{14\%,\,8\text{ yrs}})$$
$$= \text{INR } 12\,(4.639) + \text{INR } 100\,(0.351) = \text{INR } 90.77$$

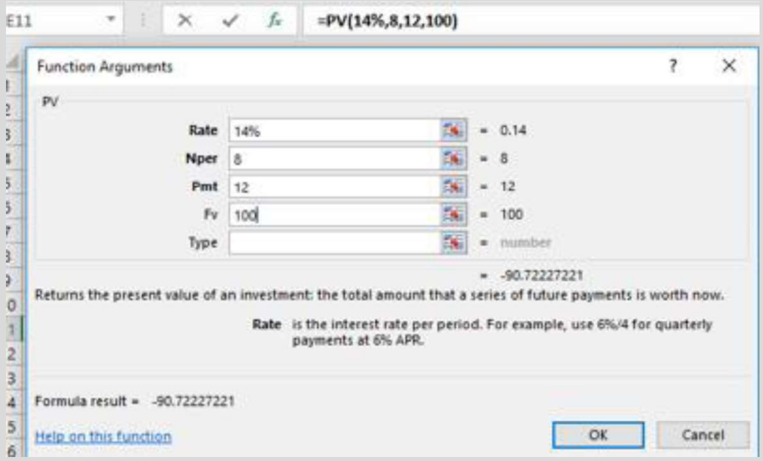
This can be solved in a spreadsheet using the PV function as follows:

[135] PVA is the Present Value Annuity Factor. It is calculated as the annuity factor for 'n' time periods at a rate of return 'r' as PVA(n,r) = $(1 - (1 + r)^{-n}) / r$. In the given case it would be = (1-(1+0.14)^(-8))/(.14) = 4.639.

On similar lines, when any future number is multiplied by the PV factor, we arrive at its present value. The PV factor is calculated as 1/(1+r)^n where 'n' is the number of time periods and 'r' is the rate of return. In the given case, the PV factor = 1/(1+0.14)^8 = 0.351.

Both these factors can be calculated using the formulae stated above on a calculator or a spreadsheet. For ready reference, these factors can also be looked up on annuity factor tables and discounting factor tables that are found on the internet in a google search. Printed table books are also available either as separate publications or as appendices at the end of finance text books.

=PV(14%,8,12,100)



Where, rate = the required rate of return; Nper = tenure of the bond; Pmt = coupon payments; Fv = future value of the bond.

Illustration 11.2

A INR 1,000 par value bond, bearing a coupon rate of 14 percent, will mature after 5 years. The required rate of return on this bond is 13 percent. What is the value of this bond?

Since the annual interest payment will be INR 140 for 5 years and the principal repayment will be INR 1,000 at the end of 5 years, the present value of the bond will be:

V = INR 140 (PVA $_{13\%,5\text{ yrs}}$) + INR 1,000 (PV$_{13\%,5\text{ yrs}}$)

= INR 140 (3.517) + INR 1,000 (0.543)

= INR 1,035.4

It can also be solved in a spreadsheet as: =PV(13%,5,140,1000)

11.3 Approaches to Equity Valuation

Similar approach as above can be used to estimate the value of an equity share in a company from an investor perspective using the present value of its expected dividend cash flow in future. However, this approach has limited relevance for alternative investments which are primarily made in unlisted companies that have high growth potential. So, the emphasis here is not on distribution of profits but to generate high valuation with internal growth. Many of such investee companies may also lack sufficient distributable surplus. Therefore, there is a need to look at valuation of the business of the investee company to arrive at the valuation of its share.

11.4 Approaches to Business Valuation

Though several approaches to valuation are available as shown above, the ones that are mainly used are (i) the earnings approach based on DCF analysis (income approach), (ii) the relative valuation based on earnings multiples (market approach) and (iii) the asset based approach (cost approach). The income or earnings based approach often scores over the other methods such as asset based methods (cost approach) and relative valuation based on market multiples. This is because the cost approach does not consider some critical drivers of value as the income approach. However, the income approach has several judgemental factors and assumptions to be made which make it quite subjective. The use of relative valuation is tricky since it requires comparing 'an apple to an apple'. Therefore, the valuation could be misleading if comparable data is not available for a particular business. As such, when business models are unique or comparable data is not available, the relative valuation approach may not be appropriate. The following chart summarises the various approaches to business valuation.

Business Valuation Overview[136]

BUSINESS VALUATION APPROACHES

Income or Earnings

Uses the future expected earnings to measure the Free Cash Flow of the company to measure value. Value can be estimated either using firm cash flow or equity cash flow and discounting it appropriately. This method is known as the DCF method.

Earnings capitalisation method may also be used as an alternative, though DCF methodology is more comprehensive.

Economic Profit

Uses the economic profit of a company in a given period and measures value of the company. Under this approach, value is defined as the sum of the present capital employed and the present value of the projected economic profit for the future.

Other Approaches

Relative Valuation – Uses different types of market multiples. These are either trading multiples or prevailing transaction multiples.

Contingent Claim Valuation - Uses option pricing models in cash flow based valuation to factor in embedded real options.

Asset based Valuation – Uses existing assets as a base for valuation. Not considered by many as an independent method.

[136]Extracted from Investment Banking – Concepts, Analyses and Cases – Pratap Giri S. McGraw Hill 2017 Page 239

11.4.1 Enterprise Value (EV) and Equity Value

At this stage, before we attempt to understand the various methodologies available to value a business / company, it is necessary to appreciate the difference between Enterprise Value (EV) and Equity Value.

Enterprise Value (EV) is the value generated by the business regardless of whether it is financed by debt or by own cash (meaning equity). Enterprise value (EV) is measured with reference to the earning potential (gross operating cash flow) which in profit terms refers to the earnings before interest, tax, depreciation and amortisation (EBITDA) and reflects the estimate of the value of the business regardless of how it is financed. Therefore, EV is the value of the total capital in the company or business regardless of whether it is debt or equity capital.

Equity value or market capitalisation (market value of a listed company) is the value of 100% of the shares of the company (total equity capital). It measures the total value of funds belonging to equity shareholders in the company after all other on the business, including debt and preference capital have been deducted.

The relationship between Enterprise Value (EV) and Equity Value is shown below.

Enterprise Value (EV) = Equity Value (Market Cap) + Total Debt (net of cash)
+ Preference capital (if any)

Illustration 11.3

Company’s estimated Market Cap = INR 1000 crore
Long Term Debt on the balance sheet = INR 200 crore
Outstanding Preference Capital = INR 50 crore
Cash on the balance sheet = INR 5 crore
Enterprise Value = 1000 + (200-5) + 50 = INR 1245 crore

11.5 Asset based Valuation

Under this method, the value of the equity share of a company is arrived at as the ‘net asset value’ per share, i.e. the total net asset value of the company is divided by the number of outstanding shares in the company to arrive at the value per share. This method does not take into account any future value attributable to the business and considers only the market value of the assets less liabilities of the company. Asset based valuation can be done from three approaches – (1) Book Value or Net Asset Value (NAV) approach, (2) Replacement Cost approach and (3) Break-up Value approach.

Under the first method, all the assets and liabilities of the company as on the valuation date are considered at historical carrying cost in the books. If the assets and liabilities are considered only at their balance sheet values (known as 'historical cost'), then we will arrive at the 'book value' per share of the company. Book value of share of a company is normally considered the 'floor price' or the least value attributable to a 'going concern' business which is expected to continue in business in future.

Under the second method, the value of the business is estimated at the cost of replacement of the entire business on as-is-where-is basis. Essentially, the market cost of the assets and liabilities with suitable adjustments for their current position are considered. In addition to the cost of acquisition of the assets, the costs related to establishment of the business as a going-concern in its present state are considered. This method is appropriate for businesses that have high entry barriers or setting up costs

The third method considers the salvage value of a business if it were shut down on the valuation date. Therefore, this method is also known as the 'break-up value' method since it measures the current market value of the company if it is broken up and sold in individual pieces of assets. Break-up value method is used to value a company that is in distress or does not have a future business case.

Book value per share measurement based on Net Asset Value is measured as follows –

$$\textit{Book Value per Share} = \frac{\text{Equity Shareholders' funds as per balance sheet}}{\text{No. of equity shares issued and paid up}}$$

The break-up value of share of a company is measured as follows –

$$\textit{Break up Value per Share} = \frac{\text{Liquidation Value of Assets – Settlement Value of Debt}}{\text{No. of equity shares issued and paid up}}$$

Illustration 11.4

Alpha Ltd provides its summary balance sheet data as on the valuation date as shown below.

	Balance Sheet of Alpha Ltd		Rs.crore
Equity Share Capital	100,000	Fixed Assets	12,000,000
General Reserve	5,000,000	Investments	1,000,000
Revaluation Reserve	1,500,000	Current Assets	
Capital Redemption Reserve	2,500,000	Inventory	3,500,000
Debenture Redemption Reserve	2,000,000	Receivables	2,500,000
P&L Surplus	500,000	Intangible Assets	1,000,000
Long Term Debentures	4,000,000		
Bank borrowings	3,000,000		
Trade Payables	1,000,000		
Other Current Liabilities	400,000		
Total	**20,000,000**		**20,000,000**

Total number of outstanding shares is 10,000.

Further information is provided as follows.

1. The current market value of fixed assets would be 10% lower on a going concern basis. However, if they are scrapped, they would fetch 40% of their book value.
2. Inventory would cost 10% higher in the market and receivables would fetch 25% lower than book value on liquidation. Market value of payables would be 15% lower on liquidation.
3. It would cost an additional INR 20,00,000 as setting up costs for initial licences, registrations and approvals as well as pre-operative costs.
4. Intangible assets consist of trademarks and patents which would fetch INR 5 lakh more if they were sold.

I. Computation of Book Value

	Rs.	Rs.
Equity Capital	1,00,000	
Cash reserves		
General reserve	50,00,000	
CRR	25,00,000	
DRR	20,00,000	
Surplus in P&L account	5,00,000	
Total Cash net worth[137]	1,00,00,000	
Tangible net worth (Equity Value of the Business)		101,00,000
No. of shares (nos.)		10,000
NAV per share (Rs)		**1,010**

[137] Cash networth does not include revaluation reserve. Hence it is excluded from valuation.

II. Computation of Break-up Value

	Rs.	Rs.
Tangible net worth as shown in table above	101,00,000	
Add appreciation in stock and intangible assets and reduction in payables (3.5L+5L+1.5L)	10,00,000	
Less depreciation in scrap value of fixed assets and receivables (72L+6.25L)	78,25,000	
Break-up value of business (Equity Value)		32,75,000
No. of shares (nos.)		10,000
Break-up value per share (Rs)		**327.50**

III. Computation of Replacement Value

	Rs.	Rs.
Book Value of Assets	200,00,000	
Add appreciation in stock, intangibles (3.5L+5L)	850,000	
Add additional setting up costs	20,00,000	
Less depreciation in fixed asset value on going concern basis	12,00,000	
Replacement Value of business (Enterprise Value)		**2,16,50,000**

Asset based valuation is not considered an independent method and when it is employed, it would more often than not be used in conjunction with other methods assigning appropriate weightage based on its overall importance in the given valuation context. As mentioned above, it is most appropriate for asset heavy businesses and distressed companies facing liquidation. It is also ideal for financial businesses such as banks and financial or investment companies.

11.6 Discounted Cash Flow (DCF) Valuation

The DCF methodology is based on finding the present value of the free cash flow of a company by discounting such cash flow at its weighted average cost of capital (WACC). The free cash flow is usually computed for a specified forecasting period of about 5 years and thereafter a perpetual terminal value is added to it. The sum of the present value of the forecasted free cash flow and the terminal value provides the present value of the company's business. From this consolidated value, the outstanding debt in the company is deducted to arrive at the equity value of the company. This equity value when divided by the number of outstanding equity shares provides the value per share in the company. The above explained process is in brief, the DCF method of valuation of a share of a company. These steps are illustrated below through an example.

Worked Out Example

In order to do the valuation of a company under the DCF method, it is required to estimate the future operating cash flow (OCF) by working out a detailed projected P&L account. This would depend on several estimates of revenues and costs to be made keeping business variables under consideration. Similarly, necessary workings have to be made for interest on borrowed capital, depreciation on fixed assets and tax liability computations. Based on the future projections, the OCF is worked out as follows –

OCF = PAT + Depreciation +/- Non-cash charges in the P&L Account +/- Changes in working capital

If there are re-investment requirements in fixed assets, these are netted out from OCF to arrive at Free Cash Flow from Operations.

For the purpose of our study, let us consider that a company has provided us with the following estimates of its Profit after Tax (PAT), Depreciation and other details for a forecasted period of next 5 years as follows.

Particulars	**Y0**	**Y1**	**Y2**	**Y3**	**Y4**	**Y5**
Profit after tax (PAT)	**1,078.00**	**1,369.29**	**1,599.40**	**1,857.51**	**2,173.29**	**2542.74**
Depreciation on Fixed Assets	8.40	10.23	11.25	12.38	13.86	15.53
Other non-cash costs to be written off from profits (estimated at 10% of PAT)	107.80	136.93	159.94	185.75	217.33	254.27
Additional investment in working capital (this is estimated as the difference	0	136.93	159.94	185.75	217.33	254.27

Particulars	Y0	Y1	Y2	Y3	Y4	Y5
between Net Current Assets at the end of the year and those at the beginning of the year = Closing NCA – Opening NCA)						
Normal capital expenditure (this is the minimum capital expenditure required year on year to keep the fixed assets in working condition)	-	2.19	2.41	2.65	2.92	3.21
Non-operating income (is not considered for valuation unless it is inherent to operations such as interest income or treasury profits)		27.55	32.16	37.34	43.68	51.10
The total number of outstanding equity shares					50,00,000	

Step1 – Free Cash Flow during the Forecasted Period

Demonstration Investee Company Limited							
Year ending March (in Rs. Lakh)		**Y0**	**Y1**	**Y2**	**Y3**	**Y4**	**Y5**
Free Cash Flow Computation							
Profit After Tax		**1,078.00**	**1,369.29**	**1,599.40**	**1,857.51**	**2,173.29**	**2,542.74**
Depreciation		8.40	10.23	11.25	12.38	13.87	15.53
Other Amortisations	10%	107.80	136.93	159.94	185.75	217.33	254.27
Gross Free Cash Flow		**1,194.20**	**1,516.45**	**1,770.58**	**2,055.64**	**2,404.48**	**2,812.55**
Changes in working capital	10%	-	136.93	159.94	185.75	217.33	254.27
Capital commitments		-	2.19	2.41	2.65	2.92	3.21
Free Operating Cash Flow		**1,194.20**	**1,377.33**	**1,608.24**	**1,867.24**	**2,184.24**	**2,555.06**
Non-Operating Income	2%		27.55	32.16	37.34	43.68	51.10
Total Free Cash Flow		**1,194.20**	**1,404.87**	**1,640.40**	**1,904.58**	**2,227.92**	**2,606.17**

Depreciation and amortisations are added back since they are non-cash items appearing in the P&L account. 'Changes in working capital' is either a deduction or an addition depending upon whether the net working capital has increased or decreased during the year. Capital commitments (capital expenditure) are the normal capital expenditure requirement on an on-going basis. Such on-going capex and working capital investments are required in any business and are known as reinvestment requirements. These are subtracted along with debt repayments (if any on long term account) from the operating cash flow generated during the year to arrive at the free cash flow.

Step 2 – The Terminal Value

The terminal value of the free cash flow (FCF) after the forecasted period is the last leg for future cash flow determination. This is calculated to perpetuity to capture the value of the cash flow that accrues after the forecasted period. It is calculated by considering the FCF for the T+1 year if 'T' is the last year of the forecasted period. The FCF of the T+1 year is then valued to perpetuity as follows –

$$\text{Terminal Value of FCF} = \frac{FCF_{T+1}}{WACC - g}$$

Wherein 'g' is the expected growth rate of PAT after the discrete period and 'WACC' is the weighted average cost of capital.

Step 3 – Determination of Cost of Capital

The DCF method requires the adoption of a weighted average cost of capital (WACC) which will be used to discount the cash flow to arrive at its present value. The WACC is estimated by taking the individual post-tax cost of debt and the cost of equity separately and multiplying them in the ratio of debt to equity in the capital structure. The cost of debt is considered at the average carrying cost in the balance sheet or the marginal cost of borrowing whichever is appropriate for the company. The cost of equity is usually based on the Capital Asset Pricing Model (CAPM) but is adjusted to reflect the illiquidity premium of alternative assets and further specific risk premium if any applicable to the given company. Accordingly, the cost of equity of an unlisted company will be higher than that of a comparable listed company. The concepts of CAPM and WACC are illustrated in Box 11.1 and Box 11.2 respectively.

Box 11.1: THE CAPITAL ASSET PRICING MODEL

The CAPM postulates that the cost of equity (opportunity cost of the shareholder) is the sum of the return on risk-free securities and the product of company's systematic risk (beta) multiplied by the market price of risk (market risk premium). It is represented as follows –

Cost of Equity = R_f + Equity beta * (ER – R_f) where,

R_f = risk free rate of return

ER = market rate of return on equity and

ER - R_f = the market risk premium for equity (known as '*systematic risk'*)

Equity beta = the volatility of the return on the stock of the company relative to return on the market.

Illustration

R_f = 6.0% (rate offered on dated government securities)

ER = 15% (average return from the equity market)

Market risk premium = 9% (i.e. 15% - 6%)

Beta = 1.10 (assumed for a company)

Cost of equity for the company = 6% + 1.10 * (9%) = 15.9%

Box 11.2: COMPUTATION OF WEIGHTED AVERAGE COST OF CAPITAL (WACC)

Let us consider the Cost of long term debt capital of a company is 12.5% pre-tax. Assuming a tax rate of 30%, the post-tax cost of debt is 8.75% (i.e. 12.5 * (1-0.3)) considering the tax shelter provided by the interest paid on the loan. With the help of CAPM (adjusted for any specific risk premium on the company), let us consider the Cost of Equity is determined at 17.5%.

The WACC will be based on the Debt-Equity Ratio (DER) of the company. If the DER is, say 1.5:1, it means the debt percentage in the total capital structure is 1.5 / 2.5 = 60%. Hence equity = 40%. Therefore, the cost of debt will be 8.75 x 60% = 5.25%. The cost of equity would be 17.5 x 40% = 7%.

The WACC would be arrived at by adding the two components, i.e. 5.25% + 7% = 12.25%

The computation of DCF value based on the above discussion is provided below in Step 4 for the data already computed under Step 1.

In the given computation below, the WACC is considered at 11.35% based on separate consideration of the cost of debt (k_d) and the cost of equity (k_e) at the appropriate weightages based on their ratio in the capital structure. The terminal growth rate has been assumed at 5%. Normally terminal growth rates for consolidated industries are considered at 2-3% above the inflation rate. Therefore, if inflation is 3%, the growth rate could be about 5-6%. In high growth or sunrise industries which are expected to maintain significant growth for a long period of time, there is a justification to take higher terminal growth rates. The consideration of the terminal growth rate is very significant as it influences the value of shares almost all by itself in young companies. Since venture capital funds and private equity funds deal with young and growing unlisted companies, the terminal growth rate could be an important parameter for the investor to consider if DCF analysis is being used to measure the value of the company.

Step 4 – Arriving at DCF Value of an Equity Share

DCF Valuation (in Rs. Lakh)		Y1	Y2	Y3	Y4	Y5	TVF
Explicit forecast period		1	2	3	4	5	6
WACC	**11.35%**						
Discount factor		0.8980	0.8065	0.7242	0.6504	0.5841	0.5245
FCF		1,404.87	1,640.40	1,904.58	2,227.92	2,606.17	
PV of FCF	**4,151.26**	1,261.62	1,322.92	1,379.35	1,448.99	1,522.16	
Continuing value							
Terminal growth rate of FCF	5.00%	Assumption					
Terminal Value	**43062.54**						
PV of TV	**22586.53**						
Value of firm							
Enterprise Value	**26,737.79**						
Less: Debt (assumed)	1,324.00						
Equity Value	**25,413.79**						
No. of outstanding equity shares	50						
Value/share (Rs.)	**508.28**						

In the above computation, the cash flows have been discounted at the WACC and accordingly, the PV of the FCF and the PV of the TV are obtained. The discounting factors (PV factors) for each year are provided in the computation using 11.35% as the discounting rate. The Terminal Value (TV) is calculated as FCF of the last year (Year5x(1+g)/(WACC-g). This provides a value of INR 43062.54. This value is discounted at the factor applicable to the TV, i.e. the TVF of 0.5245 to arrive at the PV of the TV.

The sum of the two values provides the Enterprise Value of the company, i.e. PV of FCF + PV of TV.

The Enterprise Value is reduced by the amount of debt outstanding which is assumed above as INR 1324. After the deduction of outstanding debt, the resultant value provides the equity value of the business. Dividing this value by the number of outstanding equity shares (issued capital as of date) provides the Value per share of the company.

11.7 Relative or Multiple based Valuation

'Relative valuation' is an approach that believes that assets and firms have to be valued on the basis of their current market price. The methodology involves the use of certain standardised multiples that can derive value and enable inter firm comparison and value benchmarking. It is due to this reason that this method is known as relative valuation. The popularity of this approach stems from the fact that it is easier to explain and less quantitative than the DCF approach. Relative valuation is widely used by research analysts, transaction bankers, investors, brokers and other market participants, both in the capital market and in the alternative investment space.

For a transaction to be properly priced, it is the current market value that is relevant. Relative valuation becomes the key to address this issue. However, relative valuation suffers from some disadvantages as well – (a) it does not take into account the future capital expenditure and incremental working capital requirements which could have a significant impact on value, (b) it is suitable only when companies have reached maturity and are quite stable in their future outlook, (c) the selection of multiples is subjective and (d) multiples are driven by external factors which could alter a company's valuation without there being any fundamental shift in its intrinsic value between two given points of time.

Relative valuation is based on multiples that are adopted from two different approaches – (1) 'Earnings based multiples' (also known as 'Transaction Comparables' or 'Deal Comps') and (2) 'Market based multiples' (also known as 'Trading Comps'). In the former category the most commonly used are the EV/EBITDA multiple and EV/Sales or EV/Revenue multiple (also known as 'topline multiple'). In the 'Trading comp' category, the most common are the Price-Earnings Multiple (P/E Ratio) and the Price-Book Value Multiple (P/BV Ratio).

The P/E ratio is the most widely used market related multiple in valuation. However, there are also those firms that are not listed and therefore lack a market price validation. Therefore, for unlisted companies, trading comps are quite unsuitable and at best, current market multiples applicable to listed surrogates may be used to value unlisted companies. To overcome this difficulty, over the years, relative valuation has developed 'firm value multiples' as well that determine the value without reference to the market price. Herein we will discuss the important firm value multiples. It may however be noted that, relative valuation methods determine the Enterprise value. In order to arrive at the Equity Value, the book value or market value of outstanding debt has to be deducted from the Enterprise Value.

11.7.1 EBITDA Multiple

The first multiple is the *'Enterprise Value to EBITDA multiple'* that is computed as follows –

$$\frac{\textbf{EV}}{\textbf{EBITDA}} = \frac{\textbf{Value of Firm}}{\textbf{EBITDA}}$$

Higher the above multiple, higher is the value of the company (see Box 11.5).

The advantage of using the EBITDA (Earnings before Interest, Tax, Depreciation and Amortisations) in the place of PAT is that EBITDA is a measure of operational efficiency. Therefore, higher the EBITDA, higher would be the return on investment (ROI) and hence the efficiency of the capital in business. Companies are given higher EBITDA multiples in valuation looking at the above factors. Secondly, in companies where the EBITDA is positive but the profit after tax (PAT) is negative (due to high interest, depreciation and amortisation burden), this multiple provides a better measure of value. This can happen in the case of businesses with long gestation to break-even and profits such as in start-up companies in growth phase or asset heavy businesses.

Illustration 11.5

Considering the Enterprise Value in the DCF illustration in section 11.6, we can arrive at the EV/EBITDA multiple of the company –
Enterprise Value of the Company = INR 26,737.79 lakh
If the estimated EBITDA for Y1 = INR 1875 lakh
EV to EBITDA multiple = 26737.79 / 1875 = 14.26

11.7.2 Price to Book Value Multiple

The second model of relative valuation is the *'Price to Book Value multiple'* measured as –

$$\frac{\textbf{EV}}{\textbf{Networth}^{138}} = \frac{\textbf{Value of Firm}}{\textbf{Networth}}$$

This multiple can be used either with reference to the market value of a company or value determined by any other method such as DCF to understand how many times of its current book value the company is being valued at. Usually, in listed companies, if a company's market value (known as market capitalisation) is 4-5 times of its book value, it is considered a healthy valuation. In unlisted companies, the DCF value can be cross-checked with the book value multiple. However, in start-ups and other technology companies where book value could be negative, this multiple cannot be used.

Illustration 11.6

In a start-up company, the financing is usually made by equity share capital since there may not be any tangible assets to secure against debt financing. Investors usually value the company at a premium benchmarking against future cash flows. Such premium is shown in the reserves of the company. So at the time of financing, the company shows a positive net worth and book value of share based on the subscribed capital and the securities premium.

Such companies take time to show profits since they may be using their cash mainly to develop products or market by incurring huge costs. So it is customary for such companies to incur huge losses in the initial years till the business generates sufficient revenues to absorb the costs of operations. As the company keeps making losses, the accumulated losses would wipe out the reserves and may even erode the nominal value of the subscribed capital. Thus, the book value of the share can become negative.

11.7.3 Price to Earnings Multiple

This multiple is used extensively in determining the market valuation of stocks in listed companies as the price used in this metric is the current market price of the share of a company. Therefore, the P/E multiple is a very useful market metric to gauge the value of a company as a multiple of its current earning capacity. It can also be used sometimes to

[138] Networth is defined as Net Fixed Assets + Long Term Investments + Net Current Assets – Long Term Liabilities. Alternatively, Networth = Shareholders' Funds, i.e. Share Capital + Accumulated Reserves.

compare unlisted companies in alternative space to their listed peers to know the range at which they are being valued.

Illustration 11.7

Alpha Ltd has an after tax profit of INR 100 lakhs and a paid up capital of INR 200 lakhs divided into 20 lakhs shares of INR 10 each. It currently trades at a P/E multiple of 32. What is the current market price of the share?

Earnings Per Share (EPS) of the company = 10,000,000 / 2,000,000 = INR 5
Price-Earnings (P/E) ratio = 32
Current Market Price (CMP) = 32 x 5 = INR 160 per share

A few more variations that can be used in the multiple based valuation approach are the PAT multiple (Value of Firm / PAT) and the Earnings before interest and Tax (EBIT) multiple (Value of Firm /EBIT).

In early stage companies and certain other technology or service based companies, non-financial multiples may also be used. In e-commerce, the GMV multiple (gross merchandise value) is used. In telecom the ARPU (average revenue per user) is used. In the hotel industry, the ARR (average room revenue) is used sometimes. Multiples approach is very useful to validate the valuation arrived at by a different approach as it can easily be compared against peer companies both in the listed and unlisted categories as well as to industry benchmarks. A general discussion on valuation approaches for young companies is discussed in the Annexure 11.1 to this Chapter.

11.8 Valuation of AIF Portfolio Investments (Investee Companies)

Based on the above discussion, it is evident that there are multiple approaches to the valuation of an investee company's business and accordingly, the value of the portfolio held by the AIF in that company would also be subject to variation based on the method adopted. There are also five other major contributors to the change in value of an investee company. These are as follows –

1. Changes in external environment and market variables that may take the prevailing valuations up or down.
2. Changes in the business performance of the investee company.
3. Changes in the tax environment that may impose additional burden or reduce existing tax liability on the investee company.

4. Changes in the capital structure of the company due to increase or decrease in debt/equity capital.
5. Changes adopted in valuation methodology.

11.8.1 The IPEV Valuation Guidelines[139]

AIF managers are required to carry out periodic valuations of portfolio investments as part of the reporting process to investors in the funds they manage. The International Private Equity and Venture Capital Valuation Guidelines (IPEV Guidelines) is one such set of guidelines that outline recommendations, intended to represent current best practices, on the valuation of unlisted equity investments.

The basic objective of the IPEV Guidelines is to provide high-quality, uniform, globally-acceptable, principles-based valuation guidelines for private equity and venture capital industry (category I and II AIFs) so as to bring in consistency and harmony in valuation practices, irrespective of size and composition of portfolio.

The central theme of IPEV recommendations is that 'fair value[140] is the best measure of valuing private equity portfolio companies (from manager's perspective) and at fund level (from investor perspective). The Board's[141] support for fair value is based on the merit of transparency that the fair value approach provides in portfolio and accordingly, fund valuation.

The International Private Equity and Venture Capital Board (IPEV Board) entered into an understanding with the International Valuation Standards Council (IVSC) with the objective of promoting consistency between the IPEV Board's Valuation Guidelines and the IVSC's International Valuation Standards (IVSs). In summary, the IPEV Guidelines identify seven different 'most widely used' methods available to value a portfolio company.

1. **Price of previous transaction** – When the AIF makes a follow-on investment in a company, the pricing thereof becomes the implied market value of the company which can be applied to the entire investment. However, for the first investment, it

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139 https://www.privateequityvaluation.com/Portals/0/Documents/Guidelines/IPEV%20Valuation%20Guidelines%20-%20December%202022.pdf

140 Fair Value is recognised internationally as the arm's length price or the price agreed upon between a willing buyer and seller who are not connected to one another. In Indian Accounting Standards (IND-AS 113) Fair value is defined as "the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date".

141 The IPEV Valuation Guidelines are issued by the International Private Equity and Venture Capital Valuation Guidelines Board.

needs to be carried at cost at that time and revised thereafter, based on pricing of follow-on investments.

2. **Early Stage Companies** - Many seed, start-up or early-stage investments are valued using a milestone approach, or scenario analysis. For these enterprises, typically, it is difficult to gauge the probability and financial impact of the success or failure of development or research activities and to make reliable cash flow forecasts. Consequently, the most appropriate approach to measure fair value may be a valuation technique that is based on market data, and market participant assumptions as to the potential outcomes. The **option pricing method** (OPM) is also used sometimes which is a forward-looking method that considers the current equity value and then allocates that value to the various classes of equity considering a continuous distribution of outcomes, rather than focusing on distinct future scenarios.
3. **Multiples Approach** - These are commonly used for profit-making companies. Each of the financial multiples may be computed using historical, 'sustainable' or projected data. It is usual to use comparable ratios derived from the quoted markets and/or relevant recent transactions. Having decided which of the potential comparable market ratios to use, it is normal to apply a discount to the quoted market ratio to reflect illiquidity discount applicable to unlisted stock. This discount may be reduced if a fund manager believes an exit to be imminent.
4. **Net asset valuation (NAV)** - Where the investee company is not performing satisfactorily and incurring losses, or it is in the business of finance and investments, it may be valued by reference to its net tangible assets.
5. **Discounted cash flow (DCF**) - DCF is recommended to be used because it has the strongest theoretical underpinning. But DCF models are very sensitive to the assumptions made regarding discount rates and cash flows. Therefore, they need to be used when sufficient data is available to make realistic assumptions.
6. **Valuation of Debt Investments** – Debt investments with predictable periodic cash flow streams are more likely for debt funds that invest in debt securities or in project Special Purpose Vehicles (SPVs) and securitised instruments that generate steady and predictable cash flow over a period of time. DCF of the future cash flows would be a good way of valuing such entities or debt instruments. The same approach may be used for sub-ordinate debt, mezzanine capital and preference share investments which have predictable cash flows. Non-performing collateralised Debt Investments are often valued based on the value of underlying collateral, the risk of converting the collateral into cash, and the time required to convert the collateral into cash. Uncollateralised non-performing Debt Investments or Debt Investments expected to be restructured because the Investee Company is a going concern, are valued based on the most likely cash flows discounted at the rate applicable to a market purchaser of such debt. In other words, it shall be the cost of capital at which the purchaser of such distressed debt would discount the debt.

7. **Industry Metrics** – This approach is ideal to incorporate non-financial metrics as explained earlier in this Chapter. Some industries such as e-commerce, telecom, hospitality etc. have commonly quoted metrics that are not based on cash generation or profitability. Multiples of sales are often quoted for companies that are either loss making or where profits are not disclosed. Similarly, the growth of new subscriber businesses was characterised by the use of 'value per subscriber'. All of these methods are proxies for the future cash generation that will accrue from the business. In general, the further the valuation metric moves away from being based upon future cash generation, the greater the likelihood that it will be proved to be inaccurate.

11.9 General Approach to Fund Valuation

Fund valuation refers to the valuation of the aggregate value of the corpus of a fund or a scheme therein from time to time. Investors in unit capital of an AIF trust or in partnership interests of an AIF LLP would need to assess their position periodically based on the value of the total fund and accordingly, the value of their proportionate interests therein.

Generally, the net asset value (NAV) of the fund represents its total value and the value of the unit capital or partnership interest of an investor as the proportionate value thereof. NAV (Fair value) of a fund is equivalent to the sum of the estimated fair value of underlying portfolio investments of the AIF as on the valuation date. This type of valuation is known as the '**sum of parts valuation**' method and in AIF parlance, it is known as the '**bottom-up approach**' whereby the NAV of each portfolio asset is added up from bottom to the top as of the valuation date. However, the fair value of an investor interest would be equal to the proportionate distributable NAV of the fund as of that date after deducting taxes and statutory payments if any, outstanding fees and expenses, carried interest and other contractual deductions.

Therefore, NAV of the fund, when derived as the 'Fair Value' of underlying investments and adjusted for payables and deductions as of that date, provides the best indication of the cash flows an investor would receive at the valuation date and thereby a best measurement of the value of the investor's fund interest. This concept is particularly appropriate for Category I and II AIFs that are close-ended and investors are meant to realise cash returns on their fund interests only when realisation events occur through the sale of the underlying portfolio companies.

It may however be noted that the NAV of the fund estimated on the lines mentioned above may itself be subject to adjustments and revisions from time to time based on movements in the underlying value of portfolio investments, subsequent transactions such as realisations, external factors or change in valuation methodologies. In a nutshell, the value of a fund is the

'Adjusted NAV' of the underlying investment portfolio such that it is equivalent to the amount of cash that would be received by the investors as if all underlying portfolio of investee assets were realised as at the valuation date.

11.9.1 Fund Valuation and the J curve

Reference may be made here to the J Curve discussion made in Chapter 6. In the early stages of a fund, the fund NAV would decline to negative zones and as the fund progresses and reaches its maturity years, the NAV tends to climb. This makes it particularly difficult to assess the true NAV in the early years of the fund as too many underlying investments are yet to grow and the underlying NAVs may not be adequately representative of future outcomes in cash flow. In other words, the component of unrealised investments as a percentage of total fund value is high in the initial years. Therefore, the variance factor could be significant. But as the fund advances, makes realisations and reaches its maturity years, the valuations of the portfolio assets become more predictable and the NAV of the fund may converge more closely with its ultimate gross realisations.

11.10 Valuation Regulations[142]

Regulation 23 of the SEBI (AIF) Regulations states that all AIFs shall ensure that valuation of investments are done in the manner specified by SEBI from time to time. It further provides that:

1. The AIFs shall provide to its investors, a description of its valuation procedure and of the methodology for valuing assets.
    a. Valuation of securities for which valuation norms have already been prescribed under SEBI (Mutual Funds) Regulations, 1996 shall be carried out as per the said Regulations.
    b. 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.
    c. The PPM of AIFs shall contain details of the valuation methodology and approach adopted for each asset class of the scheme.

[142] Vide SEBI (AIF) (Second Amendment) Regulations, 2023 w.e.f. November 1, 2023.

2. Category I and Category II AIFs shall undertake valuation of their investments, at least once in every six months, by an independent valuer appointed by the AIF. The period may be enhanced to one year on approval of at least seventy-five percent of the investors by value of their investment in the AIF.

The valuation of underlying portfolio of AIF assets and accordingly, the fund valuation are an important compliance and disclosure requirements under the AIF Regulations. The emphasis on external independent valuations also needs to be noted.

11.11 Role of Valuers and Limitations of Valuation

The Investment Manager of AIFs shall appoint an independent valuer, which satisfies the following eligibility criteria:[143]

- The independent valuer shall not be an associate of manager or sponsor or trustee of the AIF.
- The independent valuer shall have at least 3 years of experience in valuation of unlisted securities.
- The independent valuer shall fulfil one of the following criteria:
    - The independent valuer is a valuer registered with Insolvency and Bankruptcy Board of India 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 may be specified by SEBI.

It may be appreciated that valuation is a judgemental process wherein at various junctures, the valuer needs to make professional judgements. In this respect, valuation is both a science and an art. There are several approaches and methods available for valuation. Within each method there are a number of variables that require an assumption to be made by the valuer.

Valuers express their opinion on the fair value and not an exact number. Over the years, regulatory and professional bodies have strived to reduce the judgemental impact on valuations. The IPEV Guidelines prescribed ‘fair value measurement’ to even out the variations caused by adopting different valuation approaches. Safeguards are also prescribed by the introduction of the Companies (Registered Valuers and Valuation) Rules, 2017 which

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

provide that only individual valuers and valuation agencies registered under these Rules are eligible to conduct valuations and issue opinions on valuation.

According to the IPEV Guidelines, the valuers should exercise their judgement to select the valuation technique(s) most appropriate for a particular investment. The key criterion in selecting a valuation method is that it should be appropriate in light of the nature, facts and circumstances of the investment and in the expected view of market participants.
This will include consideration of factors such as:

- the relative applicability of the techniques used, given the nature of the industry
- market conditions as on the valuation date;
- the quality and reliability of the data available for a particular method to be adopted;
- the comparability of company or transaction data;
- the stage of development of the company;
- the ability of the company to generate maintainable profits or positive cash flow;
- any additional considerations unique to the company; and
- updating or calibrating the data on future valuation dates to reflect the current market conditions.

Fair value estimates based entirely on observable market data are deemed less subjective than those based on assumptions made by the valuer.

11.12 Distributor Responsibility to Investors

Despite developments in professional standards, use of data technology and regulatory oversight, valuations both at portfolio level and fund level cannot be free from variations and judgemental factors. Distributors need to educate their investors on the limitations of valuation based on the discussion in this Chapter so that they have a better idea about how to deal with valuation information received from fund managers from time to time. Investors need to be briefed on the basic framework of fund interest value and the various factors influencing underlying valuations. In Category I AIFs, there would be several early stage and young companies, some of which may not be amenable to traditional valuation methods. Investors need to be educated on how to read fund valuation reporting and apply their minds to it with knowledge of NAV computation and its elements.

Valuation Approaches for Start-Ups and Internet Businesses

UNIQUENESS OF START-UPS

Start-up companies are those that have little tangible assets but are technology driven / internet based business models / digital technology based services such as mobile applications, e-commerce / automation services such as artificial intelligence, machine learning, smart devices, IoT / IT enabled services such as SaaS, cloud computing, data analytics, knowledge intensive services such as healthcare, biotechnology, e-learning and education etc. These companies are popularly known as digital economy companies and are based on high skills or knowledge-intensive delivery models involving technology. Such businesses are increasingly becoming internet-driven business models and are therefore valued by adjusting traditional methods to suit the new requirements of the digital economy.

COMMON START-UP VALUATION APPROACHES

Every business start-up whether in the traditional sectors or in digital economy space are hard to value because of difficulty in forecasting their future potential and performance indicators. Some of the important factors that pose difficulty in start-up valuations are the following[144] -

1. No previous track record makes extrapolation of growth and earnings a difficult talk unlike a grown up company that has a history of successful operations.

2. Small or no revenues or in loss-making phase of operations. Since the operations are yet to scale, finding out future maintainable revenues, EBITDA and profit before tax may pose a problem.

3. Mostly dependent on equity from private sources such as founders, family, associates, angel investors, venture capitalists. So estimating the cost of holding such equity cannot be the same as holding market risk from listed companies.

4. High mortality rate – Many start-ups do not reach even Series A financing round and many others may not go much further than Series A. This is because scalability comes with a host of market and management issues that companies may not handle well. So while a few of them grow to attain the required scale, others may fall by the wayside. The difficulty in valuing start-ups should also factor in the risk of high mortality.

5. Illiquidity – Small company stock is highly illiquid as it has to grow a long way before generating buyer interest and furthermore to get listed and make its shares freely traded. Since the pipeline of investment holding is very long, start-ups attract illiquidity discount.

[144] Valuing Young, Start-up and Growth Companies: Estimation Issues and Valuation Challenges – Aswath Damodaran – Stern School of Business, NYU May 2009.

Keeping the above specific factors in mind, the popular methodology of business valuation using Discounted Cash Flow (DCF) and the Relative Valuation Methods are tweaked to address the valuation of start-ups.

DCF Method

The DCF method requires extrapolation of earnings, costs, profits and free cash flow. Many of these parameters may be hard to estimate for younger companies. The other important aspect is the growth rate and capital requirements for scalability. Therefore, the duration of forecasting is generally shorter, say 3 years and the forecasted earnings at the end of the period will typically be multiplied by a market multiple such as Sales or Revenue Multiple to arrive at the Enterprise Value of the Business after 3 years.

The next step would be to arrive at the present value of the business by discounting the future value at an appropriate discounting rate. The discounting rate used for start-ups should not only include the systematic risk (beta) but the unsystematic risk of investing in start-ups as per the factors discussed above. Analysts tend to apply a specific company risk premium (SCRP) to reflect the additional risk, though there are other more complicated alternatives. This discounting rate when applied to the future value would provide the present value of the business.

Illustration

ABC Pvt Ltd is a start-up with a few months of operation and is looking for seed financing at this stage. After assessment of the product potential and business model, the following forecast is arrived at for the company. The valuation works out as shown below.

	Y0	**Year 1**	**Year 2**	**Year 3**
	Rs. Lakh			
Revenues		25.00	40.00	80.00
Discounting Factor at 20%		0.83	0.69	0.58
Discounted Earnings (A)		20.75	27.6	46.4
Revenue Multiplier				2
Terminal Value				160
Discounted Terminal Value (B)	93			
Enterprise Value (A+B)	187.75			
Less Outstanding Debt	0.00			
Equity Value	187.75			
Less illiquidity discount (around 10%	18.75			

say)				
Equity Valuation of the company	169.00			

An alternative approach to the above could be to assume long term growth rate for the terminal value. Let's assume that in this case it works out to 5%. The valuation can then be arrived at as follows –

	Y0	**Year 1**	**Year 2**	**Year 3**
	Rs. Lakh			
Revenues		25.00	40.00	80.00
Discounting Factor at 20%		0.83	0.69	0.58
Discounted Earnings (A)		20.75	27.6	46.4
Terminal Value				$\frac{46.4 * (1 + 0.05)}{(0.2 - 0.05)} = 325$
Discounted Terminal Value (B)	188			
Enterprise Value (A+B) (also the equity value)	282.75			
Less illiquidity discount (around 10% say)	28.00			
Equity Valuation of the company	254.75			

It may be observed that assuming long term growth rates provides a significantly higher valuation for the company. This is particularly appropriate for companies that are making losses or lesser revenues presently. In such cases, the terminal value will form the bulk of the enterprise value.

Relative Valuation

In practice, analysts and investment managers often use relative valuation to value start-up companies due to the convenience of this method. However, there could be difficulties posed due to the absence of maintainable revenues or EBITDA or lack of reliable forecast for future scalability. Over the years, various surrogate parameters have come into vogue to substitute for the traditional multipliers such as revenue multiple, EBITDA multiple or PAT multiple. Some of these are mentioned below.

1. Gross Merchandise Value (GMV) – used in valuation of e-commerce companies. This is the combined value of all the goods sold by vendors using the on-line platform of the e-commerce company. Therefore, if the selling price of each article sold is added up for a period of time, say a year, it equals the GMV. GMV is not to be confused with revenues or earnings. It is merely the aggregate value of goods trafficked through the portal. The portal company earns only a small percentage of GMV as its revenue. The GMV multiplier is used to value the company, usually in the range of 2 to 5 times. For e.g. in 2014, Flipkart had a GMV of about USD 4 billion and on that basis, it was valued at USD 15 billion. One of the reasons why an operational metric like GMV was adopted for e-commerce companies is that they make heavy losses during their growth phase due to substantial discounts and sales promotion offers. They also incur heavy establishment costs on operating and ramping up their back-end operations on logistics and fulfilment centres.

2. Average Revenue Per User (ARPU) – This metric is suitable for SaaS and B2C internet services companies. As the business grows, the revenue potential per customer is assessed and the ARPU is calculated by dividing the total revenue by the number of customers from whom it was generated. A higher ARPU generation for the same number of customers gives the company a higher valuation.

3. Other Revenue Metrics – An example is the Revenue Run Rate which is the most recent month's revenue annualised for a year. This metric can be used as an estimation of the annual revenue to be used with a suitable multiple in the case of companies that are growing very fast at a month-on-month growth rate. Another example could be the Maintainable Monthly Revenue or Monthly Recurring Revenue which are used for subscription based internet services that can lock-in a customer for a period of time. Similar variants called Revenue Per Order or Contribution Margin Per Order (Revenue – Variable Cost) are used in food delivery and cloud kitchen start-ups.

4. Cost Metrics – Cost metrics such as Burn Rate and Customer Acquisition Cost are used mainly to establish the trajectory of growth and accordingly make an assessment of the multiple to be used for valuation. Higher burn rate would indicate that the growth rate could be fast but higher capital needs to be provided. It could also mean inefficiencies that may pull down the valuation.

Investors also attribute additional valuation to companies that display a high-performance team, higher levels of corporate governance and disclosure standards, better people management skills, lower level of non-compliance and litigation and other such qualitative attributes through a score card. Higher score could mean a better valuation.

Venture Capitalist Method of Valuation

This method is simple and most commonly used in VC financing of a start-up. It involves making the following assessment –

1) The terminal value of the firm at a time of expected exit in the future. This is usually estimated using the expected projected earnings at the time of exit and the average prevailing comparable multiple. It can also be assessed under the DCF method as explained above. The terminal value is discounted to present value at the estimated hurdle rate.

2) The VCs target ownership stake based on the post-money value and the amount of financing being provided to the firm.

3) The possible dilution expected due to future fund raising by the company until the exit date (known as the 'dilution factor'). There has to be a suitable upward adjustment to the target stake to accommodate the dilution factor.

The stake required is calculated as follows -

$$\% \text{ stake} = \frac{\text{Investment proposed}}{\text{Post-money valuation}}$$

which is,

$$\% \text{ stake} = \frac{\text{Investment proposed}}{\text{Future Valuation} / (1+ \text{Discount rate})^{\text{No. of years}}}$$

A variation of the above method is the *'First Chicago Method'* wherein three scenarios, the best, the worst and the survival scenarios are plotted to get three different valuations. These are assigned appropriate weights to arrive at a weighted average valuation. This weighted valuation is discounted to arrive at the present value and the stake to be offered.

Illustration

From the following details, the stake to be offered to a VC under the Conventional VC method is shown below.

1. The current level of earnings (R) = INR 10 crore
2. The expected annual growth rate of revenue (r) = 50%
3. The required capital at present round = INR 20 crore
4. Expected holding period = 5 years
5. Expected Profit after tax margin at liquidity event = 12%

6. Expected Market P/E ratio = 35
7. Expected rate of return (d) for the VC = 40%

The first step is to extrapolate the revenues at the end of five years at a CAGR of 50%. This comes close to INR 76 crore which forms the revenues at the end of year 5.

The PAT thereon @ 12% works out to INR 9.12 crore.

The PAT capitalised at a P/E ratio of 35 yields a valuation of INR 319 crore

The required present value factor = (1+0.40)^5 = 5.378

The present value of the company = 319 / 5.378 = INR 59.35, say INR 60 crore.

The stake to be offered to the VC = 20 / 60 = 33%

If expected dilution factor is 20%, the retention will be 80%. So in order to protect dilution, the required stake goes upto 33/(1-0.2) = 25/0.8 = 41.25%

Sample Questions: Chapter 11

1. Relative valuation method consists of:

a. valuing with multiples of established parameters

b. valuation based on common P/E ratio

c. finding the comparable cash flow

d. discounting the relative cash flow

2. Break-up value of share is arrived at using _______.

a. assets and liabilities at book value

b. assets and liabilities at replacement value

c. assets and liabilities at liquidation value

d. net assets at book value

3. The terminal value of a company is ____________.

a. the value at the end of its life

b. the continuing value beyond the discrete period

c. the acquisition value to an acquirer

d. the negotiated value with the investor

4. Capital asset pricing model (CAPM) is a method to arrive at the market value of the capital of a company based on the market price of its assets. State whether True or False.

a. True

b. False

5. Weighted average cost of capital (WACC) is used as the discounting rate in a DCF model. State whether True or False.

a. True

b. False

LEARNING OBJECTIVES:

After studying this chapter, you should know about:

- Various aspects related to AIF taxation
- Withholding of tax by an AIF and withholding of tax by the Indian portfolio companies
- Reporting compliances for AIF under Income Tax Act
- Taxation for residents and non-residents in India (DTAA and TRC)
- Relevant indirect taxes (GST, Stamp Duty and Local Taxes)
- Basics of General Anti-Avoidance Rules (GAAR)
- FATCA and CRS Provisions

This Chapter discusses broadly about the taxation framework applicable to AIF activity in India under the Income Tax Act, 1961 (hereinafter referred to as the ITA) and its subordinated legislation. Associated discussion on taxation of investors (domestic and non-resident) are also provided as found applicable. However, the basic scheme of taxation under the ITA for the investors and computational requirements are not discussed since they are outside the scope of this workbook.

12.1 Basic Framework

In respect of investors, the basis of charge under ITA depends upon the residential status of the taxpayer during a tax year, as well as the nature of the income earned. A person (natural or juridical) who is a resident in India is liable to taxation in India on worldwide income, subject to certain tax exemptions / deductions as may be applicable. A person who is treated as non-resident for Indian tax purposes is generally subject to tax in India only on such person's Indian-sourced income or income accrued, received or deemed to be accrued or received in India.

12.2 AIF Taxation

AIFs can be in the form of a trust, a limited liability partnership (LLP), a company or a body corporate. Majority of the AIFs are constituted as a contributory, determinate, irrevocable trust under the Indian Trusts Act, 1882. AIFs are required to be registered with SEBI under the AIF Regulations (or migrated from the erstwhile Venture Capital Regulations).

The taxability of Category I and II AIFs is governed by Section 10(23FBA), 10(23FBB), 194LBB and 115UB (Chapter XII – FB - Special Provisions Relating to Tax on Income of Investment Funds and Income Received from such Funds) of the ITA.

The ITA has accorded tax pass through status to 'Investment Funds' with respect to income (other than business income from investments). The term 'Investment Fund' is defined under Section 115UB of the ITA as "any fund established or incorporated in India in the form of a trust or a company or a limited liability partnership or a body corporate which has been granted a certificate of registration as a Category I or a Category II Alternative Investment Fund and is regulated under the SEBI (Alternative Investment Fund) Regulations, 2012, made under the Securities and Exchange Board of India Act, 1992 or regulated under the IFSCA (Fund Management) Regulations, 2022 made under the International Financial Services Centres Authority Act, 2019".[145] Therefore, Category I and II AIFs registered as trusts, or LLPs or companies would enjoy tax pass through status at fund level.

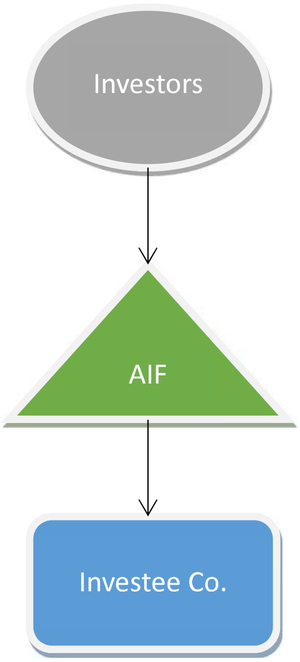
The concept of 'tax pass through' enables zero tax liability on the income (other than business income) at Investment Fund level. The income generated by the Investment Fund, other than business income, will be taxable in the hands of the beneficiaries (investors) directly as per their respective tax status.

As per section 115UB read with section 10(23FBA) of the IT Act, any income (other than business income) earned by an Investment Fund is exempt in its hands and is chargeable to income tax directly in the hands of its investors in the same manner as if it were the income accruing or arising to, or received by, such investors had the investments been made directly by them. As far as business income is concerned, section 115UB read with section 10(23FBB) states that such business income accruing or arising to or received by an Investment Fund is taxable at the fund level at: (a) the specified rate in Finance Act of the relevant year (where such fund is a company or firm); (b) the maximum marginal rate (in other cases); and is therefore exempt in the hands of the investors.

Also, as per section 115UB, any business loss at the fund level is not allowed to be passed through to its investors but is permitted to be carried forward for set-off against income of subsequent year/(s) business income in accordance with the provisions of the ITA. Loss (other than business loss) shall be allowed to be passed through to the investors and allowed to be carried forward and set-off in the hands of the investors of the AIF where the investors has held the units of the AIF for at least 12 months.

[145] Updated by the Finance Act 2023 w.e.f April 1, 2023.

The basic taxability of the Category I and Category II AIFs and the investors may be graphically depicted as under:



a. Business income- Exempt
b. Interest, dividend and capital gains- taxable on pass through basis at applicable rates
c. Loss (other than business loss)- available to the investors on pass through basis if units are held for at least 12 months

a. Business income- taxable at MMR (for other than company/firm)
b. Other income- exempt
c. Business loss- To be carried forward and set off at AIF level
d. TDS on income distributed to resident investors- 10% (Other than business income)
e. TDS on income distributed to non- resident investors- rates in force (Other than business income)
f. No TDS on business income distributed to the investors

a. If income distributes to the AIF is in nature of business income, withholding provisions shall apply, else no TDS on income distributed to the AIF.

12.2.1 Withholding of tax by an AIF

As per section 194LBB of the ITA, an Investment Fund is required to withhold tax at the rate of 10% on all income (other than business income) payable to resident investors and at the rates in force [as specified in the Finance Act of the relevant year or rates specified in the applicable Double Tax Avoidance Agreement (DTAA) entered into between India and the country of residence of such non-resident investor] as applicable on all income (other than business income) payable to non-resident investors at the time of credit or payment, whichever is earlier. Investors are entitled to claim credit of taxes so withheld by the Investment Fund in their respective returns of income which are to be filed under the ITA.

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.

12.2.2 Withholding of tax by the Indian portfolio companies

As per section 197A(1F) of the ITA and the notification issued by the CBDT[146], the payer of the income to an Investment Fund is not required to withhold any taxes while paying or crediting income (other than business income) to such Investment Fund. Therefore, the fund would not suffer any withholding of taxes from its non-business income.

12.2.3 Reporting compliances to be undertaken by the AIF under the ITA

It is mandatory for the Investment Fund to file its return of income as per the provisions of the ITA.

Further, the provisions of Section 115UB of the ITA read with Rule 12CB(1) of the Income-tax Rules, 1962 ('IT Rules') prescribe that the statement of income paid or credited by an Investment Fund to its unit holder in a given financial year shall be furnished by the person responsible for crediting or making payment of the income on behalf of an Investment Fund and the Investment Fund to the unit holder by 30th day of June of the following financial year. The prescribed form provided for this purpose is Form No. 64C, which is to be duly verified by the person paying or crediting the income on behalf of the Investment Fund in the manner indicated therein.

Similar statement is also to be furnished electronically by the Investment Fund in Form No. 64D to the jurisdictional Principal Commissioner of the Income-tax or the Commissioner of Income-tax by 15th day of June of the following financial year, under digital signature, duly verified by a practicing Chartered Accountant.

12.3 Business Income and Investment Income

Box 12.1: PRIMER ON CAPITAL GAINS

Unlike regular investment income that accrues as interest on debt securities or as dividend distributed by companies on shares held by shareholders, capital gains are the profits that accrue due to the appreciation in the value of an asset over time. Though this is in the nature of a capital profit, the ITA recognises such profits as taxable 'capital gains'. The ITA recognises such capital gains from sale or 'transfer' of assets such as immovable properties, land, financial assets such as shares, bonds and units and some movable properties as taxable income.

146 Notification no 51/2015 dated 25 June 2015

Since capital profits are being taxed, for the purpose of providing a differential treatment to the taxation of such capital gains, the law has segregated 'short-term capital gain' (STCG) from 'long-term capital gain' (LTCG). While short-term capital gain is treated like any other income and taxed at the applicable rates (Except in case of listed shares sold on recognised stock exchanges), long-term capital gain is bestowed with a concessional tax treatment to encourage savings and investments. The differentiation between STCG and LTCG is based on the period of holding of the particular asset. The capital gain is computed as the difference between the 'sale proceeds' or 'fair market value' of the asset on the date of transfer and the 'cost of acquisition' of the asset. The law provides for different ways of arriving at two numbers in different assets and under various situations.

On similar lines, capital losses are also recognisable under the law. While short-term capital losses can be set-off against STCG or LTCG, long-term capital loss is allowed to be set-off only against LTCG due to its special scheme of taxation. Such set-offs are subject to further conditions under the law.

With regard to AIF assets, capital gains (or losses) would arise at both levels – investor level and fund level. At investor level, they arise when the units or partnership interests are sold or transferred by the investor. At the fund level, they arise when the AIF / scheme sells or transfers its underlying interests in portfolio companies. The following discussions deal with inter alia, brief overview of taxation of income earned by such AIF or/and the unit holders of the AIF both from a resident and non-resident perspective.

12.3.1 Characterisation of income

Traditionally, the issue of characterisation of exit gains (whether taxable as business income or capital gains) has been a subject matter of litigation with the Indian tax authorities. There have been judicial pronouncements on whether gains from transactions in securities should be taxed as 'business income' or as 'capital gains'. However, these pronouncements, while laying down certain guiding principles have largely been driven by the facts and circumstances of each case. Also, the Central Board of Direct Taxes (CBDT) has provided guidance[147] in respect of characterisation of gains as either capital gains or business income. Following are the key illustrative factors indicative of capital gains characterisation (not business income):

- Intention at the time of acquisition – capital appreciation
- Low transaction frequency
- Long period of holding
- Shown as investments in books of account (as against stock in trade)
- Use of owned funds (as opposed to borrowed funds) for acquisition
- Higher level of control over the investee company

[147] *Vide* its Instruction No. 1827, dated 31 August 1989 and Circular No. 4/2007, dated 15 June 2007.

Regarding characterisation of income from transactions in listed shares and securities, the CBDT had issued a circular[148], wherein with a view to reduce litigation and maintain consistency in approach in assessments, it has instructed that income arising from transfer of listed shares and securities, which are held for more than twelve months would be taxed under the head 'capital gains' unless the tax-payer itself treats these as its stock-in-trade and gain on transfer thereof as its business income.

In the context of transfer of unlisted shares, the CBDT has issued a clarification[149] stating that income arising from transfer of unlisted shares would be considered under the head 'capital gains' irrespective of the period of holding with a view to avoid dispute / litigation and to maintain uniform approach. However, the above shall not apply in the following cases:

- The genuineness of transactions in unlisted shares itself is questionable; or
- The transfer of unlisted shares is related to an issue pertaining to lifting of corporate veil; or
- The transfer of unlisted shares is made along with the control and management of underlying business (CBDT has issued clarification[150] stating that the exception to transfer of unlisted securities made along with control and management of underlying business would not apply to Category I and II AIFs) and Indian tax authorities would take appropriate view in such situations.

Due to the above position under law, if the activities of Category I and II AIFs comply with the conditions and parameters mentioned in the CBDT circulars and instructions, the income from transfer of securities of companies should generally be categorised as capital gains.

12.3.2 Taxation in the hands of Investors

The ITA provides that any income with respect to which the Investment is eligible for tax pass through should be exempt from tax in the hands of the Investment Fund and should be chargeable to tax directly in the hands of the investors as under:

- The income should be chargeable to tax in the hands of the investors in the same manner as if it were the income accruing or arising to, or received by the investor, had the investments, made by the Fund, and been made directly by the investor.
- The income paid or credited by the Fund should be deemed to be of the same nature and in the same proportion in the hands of the investors as if it had been received by, or had accrued or arisen to, the Investment Fund.

[148] *vide* Circular No. 6 of 2016 dated 29 February 2016
[149] *vide* Instruction No. F.No. 225/12/2016/ ITA.II dated 2 May 2016
[150] Letter F.No. 225/12/2016/ITA. II, Dated 24 January 2017

- The income accruing or arising to, or received by, the Investment Fund, during the previous year, if not paid or credited to the investor should be deemed to have been credited to the account of the investor on the last day of the previous year in the same proportion in which such investor would have been entitled to receive the income had it been paid in the previous year.
- Once the income is included in the total income of the investor in a previous year, on account of having been accrued or arisen in the said previous year, it should not be included in the total income of such investor in the year in which such sum is actually paid to the investor by the Investment Fund.
- Losses, other than business losses, shall be passed through to the unit holders, if such losses arise in respect of units held by the unit holders for more than 12 months.
- Unit holders are 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.
- As stated above, business income should be subject to tax at the Investment Fund level at the applicable maximum marginal rate and should be exempt from tax in the hands of the investor.

The AIF generally earns income in the following nature from its portfolio investments (i.e. investments in debt securities/equity instruments etc.):

- Dividend income
- Interest income; and
- Exit gains arising in the form of sale or buy back or transfer of securities held in portfolio entities.

The tax implications in the hands of the resident investors and non-resident investors (where income is not characterised as business income in the hands of the Investment Fund) are discussed in the subsequent paragraphs.

12.4 Taxation for residents in India

1. Interest income is to be taxed in the hands of resident investors at the tax rates applicable for each investor.
2. The Indian company declaring dividend are not required to pay any dividend distribution tax on dividend distributed/paid/declared to its shareholders. The

dividend income is taxable in the hands of the shareholders at applicable rates (plus applicable surcharge and health and education cess). Further, the investor can claim a deduction of interest expenditure under section 57 of the ITA against such dividend income up to 20% of the dividend income where investments are made by utilising borrowed funds.

3. Capital gains arising from the transfer of securities of the portfolio entities would be taxed as long term capital gains or short-term capital gains based on the period of holding of the investments. Further, the rate of tax will also depend on the mode of exit and nature of securities (listed or unlisted).
4. Conversion of debentures of an Indian company into equity shares of that company is not regarded as a taxable transfer under the ITA. Hence, no capital gains would arise in the hands of the Investment Fund on conversion of any convertible debentures of a company into equity shares. At the time of transfer of such converted shares, the cost of acquisition of such converted debentures will be deemed to be the cost of acquisition of such equity shares. Further, the holding period of such equity shares should be deemed to commence from the date of acquisition of such debentures irrespective of date of conversion.
5. Conversion of preference shares of an Indian company into equity shares is not regarded as a taxable transfer under the ITA. Hence, no capital gains will arise in the hands of the fund on such conversion. For computation of capital gains on transfer of equity shares, the holding period for the resulting equity shares should include the holding period of the converted preference shares and the cost of acquisition of the resulting equity shares should be the cost of acquisition of the converted preference share.
6. As per section 10(34A) of the ITA, gains arising on buy back of shares shall be exempt in the hands of the investors.
7. The share of a partner in the total income of an LLP (portfolio entity), would be exempt from tax in the hands of such partner. Accordingly, such share of profits from an LLP on a tax pass through basis should be exempt from tax in the hands of the Investors of the Fund.
8. When an investor exits an AIF by a transfer of units or partnership interests to another investor (this transaction is called a ‘secondary transfer’), gains on sale of units may be taxable directly in the hands of the investors. The tax implications will depend on the characterisation of the gains as ‘capital gains’ or ‘business income’.
9. Section 56(2)(x) of the ITA provides that if a person acquires any property (which includes securities such as equity shares, debentures, preference shares, etc.) at a price which is lower than its fair market value (FMV) to be computed in the prescribed manner, the difference between the FMV and actual consideration (if greater than INR 50,000) shall be taxable in the hands of the recipient of such security as other income.
10. Corporate beneficiaries are subject to the provisions of Minimum Alternate Tax (MAT) contained in Section 115JB of the Income Tax Act, 1961.

12.5 Taxation of Non-residents in India

12.5.1 Double Taxation Avoidance Agreements

The taxation of offshore investors (NRIs and other non-residents) is governed by the provisions of the ITA, read with the provisions of the Double Taxation Avoidance Agreement between India and the country of residence of such offshore investor. Double Taxation Avoidance Agreements (DTAAs) are bilateral tax treaties signed by the governments of two countries that aim to avoid or eliminate double taxation of the same income in both the countries. This is possible when the resident of one country earns income from the other country and based on the respective tax laws of the two countries, the person may pay tax based on the source of income (called source based taxation) in one country and pay tax again in the country of residence (called residence based taxation). DTAAs are essential to remove such undue hardship and promote cross-border investment of capital. DTAAs also have wider implications for world economy by enabling capital to get globalised and earn better returns and be put to better use. India has signed DTAAs with most of the important financial jurisdictions of the world to promote global capital investment in India.

As per section 90(2) of the ITA, the provisions of the ITA would apply to the extent they are more beneficial than the provisions of the DTAA (subject to GAAR provisions). Accordingly, availability of DTAA benefits should be a relevant factor in determining the Indian tax consequences in respect of such income in the hands of offshore investors. Distributors need to take note of this fact while marketing AIF products to offshore investors. In recent times, observing that several international investors have resorted to treaty shopping and tax avoidance, the Organisation for Economic Cooperation and Development (OECD) began a framework to address the problem. Under this framework, countries can sign a multilateral instrument (MLI). The MLI is a multilateral treaty that enables countries to swiftly modify their bilateral tax treaties to implement measures designed to better address tax avoidance. The DTAA will therefore need to be read along with the tax treaties and the MLI of India coming into effect. The MLI will apply alongside the DTAA and either supplement, complement, supersede or modify the application of the DTAA, thus impacting the tax implications relevant to the offshore investor.

The taxability of the income earned from the AIF by the offshore investors, in the absence of DTAA benefits, would be as per the provisions of the ITA. DTAA benefits have to be examined and understood properly by the offshore investors with suitable professional advice in this regard.

12.5.2 Tax Residency Certificate (TRC)

In order to be eligible to claim the benefits of DTAA, the offshore investor should inter alia, have a valid TRC issued by the tax authorities of his country of residence and must be renewed on an annual basis. The ITA provides that a non-resident will not be entitled to claim any relief under a DTAA, unless a TRC, of it being a resident in any country outside India or specified territory outside India, as the case may be, is obtained by it from the government of that country or specified territory. The CBDT also prescribed certain information which is to be provided in Form 10F (to be produced along with the TRC), if such information does not form part of the TRC. Further, additional documents and information must also be provided, if called upon. The offshore investor will be required to keep and maintain the documents that are necessary to substantiate the above information.

12.5.3 Taxation of various incomes in the hands of non-resident investor

The broad framework for taxation of non-residents for various investment incomes in India is provided below. These will however be subject to DTAA benefits, if any, available in the cases of respective investors.

1. Interest income is taxable in India at varying applicable rates for foreign companies, other incorporated bodies and individuals. Therefore, the tax liability could vary based on the status of the investor.
2. The Indian company declaring dividend are not required to pay any dividend distribution tax on dividend distributed/paid/declared to its shareholders. The dividend income is taxable in the hands of the shareholders at applicable rates (plus applicable surcharge and health and education cess). Further, the investor can claim a deduction of interest expenditure under section 57 of the ITA against such dividend income up to 20% of the dividend income where investments are made by utilizing the borrowed funds.
3. As far as investment gains from transfer or sale of securities is concerned, in most of the cases, the treatment should follow on similar lines as in the case of domestic investors. Additionally, in case of non-resident investors beneficial tax rate is provided for the long term capital gains arising on transfer of unlisted securities or shares of a company not being a company in which the public are substantially interested subject to the condition that the indexation and foreign exchange fluctuation benefits would not be available.
4. Tax treatment on buyback of shares of a company would be identical to what is discussed above in the case of resident investors.
5. The tax treatment of exits on transfer and winding up of AIF interests by the investor should follow similar treatment as discussed above for resident investors.
6. The tax treatment on conversion of convertible debt securities and preference shares should follow similar treatment as discussed above for resident investors.
7. The share of a partner in the total income of an LLP (portfolio entity), would be exempt from tax in the hands of such partner. Accordingly, such share of profits from an LLP

on a tax pass through basis should be exempt from tax in the hands of the Investors of the Fund.

8. Section 56(2)(x) of the ITA provides that if a person acquires any property (which includes securities such as equity shares, debentures, preference shares, etc.) at a price which is lower than its fair market value (FMV) to be computed in the prescribed manner, the difference between the FMV and actual consideration (if greater than INR 50,000) shall be taxable in the hands of the recipient of such security as other income.
9. The CBDT has provided a clarification vide circular dated 3 July 2019 that any income in the hands of a non-resident investor from offshore investments routed through the Category I or Category II AIF, being a deemed direct investment outside India by the non-resident investor, is not taxable in India under the provisions of the ITA. The CBDT further clarifies that loss arising from the offshore investment relating to non-resident investor, being an exempt loss, shall not be allowed to be set-off or carried-forward and set off against the income of the Category I or Category II AIF.
10. Section 9 of the ITA, transfer of shares or other interest in an offshore company or an offshore entity which derives, directly or indirectly, its value substantially from the assets located in India could be subject to indirect transfer tax provisions in India. Share or interest of a foreign company or entity should be deemed to derive its value 'substantially' from the assets located in India if on the 'specified date', the value of such Indian assets (i) exceeds INR 10 crore; and (ii) represents at least 50% of the value of all the assets owned by such foreign company or entity. The value of assets will have to be taken at the fair market value on the 'specified date' without reduction of liabilities, if any, in respect of the asset. Further, there are certain reliefs provided to the investors from the application of the provisions of indirect transfer.

The above Indirect Transfer Provisions could result in potential tax liability upon the redemption and / or the transfer of the interest held by the non-resident investor in the Investment Fund through an offshore entity i.e. where investments are made by the non-resident investor through feeder fund. However, such taxation should be subject to any relief that any such investors may be entitled to under the applicable DTAA. It would be important to note that requirements with respect to obtaining a TRC, filing the relevant form (Form 10F presently) and filing tax returns would also be applicable to such underlying investors claiming relief under the DTAA.

The CBDT vide a circular clarified that the indirect tax provisions are not applicable to dividends declared by a foreign company outside India that does not have the effect of transferring any underlying assets located in India. In light of this circular, distributions made by the offshore feeder fund or other entity through which investment was made in India should not fall within the ambit of provisions relating to taxation of indirect transfers.

Further, the CBDT has clarified that indirect transfer provisions should not apply in respect of income accruing or arising to a non-resident on account of redemption or buy-back of its shares or interest held in offshore feeder fund through which the investment in AIF is made if such income accrues or arises from or in consequence of transfer of shares or securities held in India by the AIFs and such income is chargeable to tax in India. However, the said benefit should be applicable only in those cases where the proceeds of redemption or buy-back arising to the non-resident do not exceed the pro-rata share of the non-resident in the total consideration realised by AIFs from the said transfer of shares or securities in India.

12.6 General Anti-Avoidance Rules (GAAR)

The ITA contains GAAR provisions that are applicable in respect of income accruing or arising on or after 1 April 2017. General anti-avoidance rules are a set of provisions under Chapter X-A of the ITA. GAAR have been introduced by several countries and are aimed to ensure that the tax authority in a country has the power to deny tax benefit of transactions or arrangements which do not have any commercial substance and the main purpose of such a transaction is to achieve tax benefits. Therefore, GAAR may be invoked by the Indian income-tax authorities in case arrangements are found to be impermissible tax avoidance arrangements. The GAAR provisions would override the provisions of a tax treaty in cases where GAAR is invoked. A transaction can be declared as an impermissible avoidance arrangement, if the main purpose of the arrangement is to obtain tax benefit and which also satisfies at least one of the four specified test as mentioned below:

- Arrangement creates rights or obligations, which are not ordinarily created between persons dealing at arms-length;
- Arrangement directly or indirectly results in the misuse or abuse of the provisions of the ITA;
- Arrangement lacks commercial substance or is deemed to lack commercial substance in whole or in part; or
- Arrangement is entered into, or carried out, by means, or in a manner, which are not ordinarily employed by bona fide purposes.

In such cases, the tax authorities are empowered to reallocate the income from such arrangement or re-characterise or disregard the arrangement. Some of the illustrative powers are:

a. disregarding or combining or re-characterising any step of the arrangement or party to the arrangement;
b. ignoring the arrangement for the purpose of taxation law;
c. disregarding or treating any accommodating party and other party as one and the same person;

d. deeming persons who are connected to each other parties to be considered as one and the same person for the purposes of determining tax treatment of any amount;
e. relocating place of residence of a party, or location of a transaction or situs of an asset to a place other than provided in the arrangement;
f. looking through the arrangement by disregarding any corporate structure; or
g. re-characterising equity into debt, capital into revenue, etc.

12.7 Goods and Services Tax (GST)

GST will be applicable on services provided by the Investment Manager and the Trustee to the Fund. GST at the applicable rate would be levied on payments made towards investment management fee and trusteeship fees payable by the AIF to the investment manager and trustees respectively.

12.8 Stamp Duty and Local Taxes

The Fund documents and investment documents could be subject to stamp duties and other local taxes, which would differ from State to State, city to city and between municipal jurisdictions, depending on the location where these documents are executed or are required to be implemented. However, Government of India has introduced regime of uniform stamp duty rates across the country thereby simplifying the collection process. Issue, transfer and sale of units of the Fund are subject to stamp duty. The fund operations may also include professional tax, local municipal taxes or Securities Transaction Tax 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 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 or off market), unlisted securities in demat 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.[151] In this regard SEBI issued a circular stating that RTAs to collect stamp duty on issue, transfer and sale of units of AIFs.

12.9 Foreign Tax Account Compliance Act and Common Reporting Standard

Foreign Account Tax Compliance Act (FATCA) provisions were introduced in the United States Internal Revenue Code in 2010 to address concerns about revenue loss arising from offshore tax abuse, concealment of U.S. sourced income and undeclared accounts held by the United States (U.S). By signing the agreement (on 9 July 2015, effective as of 31 August 2015) India has agreed to exchange information on U.S. reportable accounts with the primary objective of tracking U.S. persons with financial accounts held in Indian financial institutions.

Although the FATCA law aims to obtain information on U.S. persons, an AIF 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 provisions. The AIF's ability to satisfy such 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 and associated details.

In order to facilitate free flow of exchange of information between different countries, the G20 countries requested the Organisation for Economic Co-operation and Development (OECD) to develop a standard. The **Common Reporting Standard** (CRS), thus developed and approved by the OECD Council on 15 July 2014, calls on jurisdictions to obtain information from their financial institutions and automatically exchange that information with other jurisdictions on an annual basis.[152] It sets out the financial account information to be exchanged, the financial institutions required to report, the different types of accounts and taxpayers covered, as well as common due diligence procedures to be followed by financial institutions. India is a signatory to exchange information under CRS from June 3, 2015.

[151] 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.
[152] https://www.oecd.org/tax/automatic-exchange/common-reporting-standard/

Sample Questions: Chapter 12

1. The following income is taxed at fund level for an AIF:

a. capital gains

b. business income

c. income from house property

d. income from other sources

2. 'Investment Fund' under the Income Tax Act 1961 means ____________.

a. an investment company registered with RBI

b. a category I or II AIF registered with SEBI

c. a category III AIF registered with SEBI

d. a company registered as NBFC

3. Withholding tax means _____________.

a. a sum deducted from any income paid

b. the tax on income not disclosed

c. additional tax and penalty for withholding information

d. tax that is withheld and carried forward to next year

4. Long term capital gains resulting from investment held for trading purposes are treated as business income. State whether True or False.

a. True

b. False

5. All types of trusts enjoy tax pass through status. State whether True or False.

a. True

b. False

CHAPTER 13: GOOD PRACTICES

LEARNING OBJECTIVES:

After studying this chapter, you should know about:

- Role of AIF Distributors
- Importance of Distributor Agreement between AIF and Distributors
- Need and relevance of Distributor pitch and scope for distributor services
- Good practices to be followed by Distributors

13.1 Introduction

The need to dwell on good practices for distributors in the AIF industry cannot be over-emphasised. India is on the cusp of an exponential growth in AIF activity and distributors form the vital link between investment managers and the investor community so as to build a robust eco-system. Considering the fact that AIF investment community consists of large institutional and HNI investors (both domestic and offshore), distributor skills and competence levels have to match up to the expectations of these informed investors. The AIF Regulations have created the platform for the demand side to grow significantly seeking more and better structured AIF products. With more AIFs being floated over time, the supply side is also becoming robust as more investment opportunities are emerging in the Indian start-up and later stage businesses. Category I and II AIFs are therefore looking at a very promising growth phase and the role of AIF distributor is becoming increasingly important.

13.2 Role of AIF Distributor

AIF distributors play a wider role as compared to their counterparts in other segments of financial product distributorship since AIF Category I and II products are primarily off-market, long-term, illiquid and higher risk-taking products. Distributors should not only understand these products better and match them to investor profiles but provide better relationship support as well. Therefore, marketing, sales, support and relationship management form the four pillars of AIF distributorship. These core functions should be actively supported with adequate research and product analysis, relationships with fund houses, investment managers, family offices and other investors. AIF products are close-ended and funds have a long gestation to close. So long term engagement with investment managers and investors is very important. It also helps in generating more investment opportunities from follow-on funds and even facilitating side-letters for discerning clients. Over time, expert skills in distribution of products based on specific requirements of client can be developed.

13.3 Distributor Agreement

The distributor agreement forms the contractual basis for distributorship of AIF products. The distributor acts as a service provider for the AIF for marketing its schemes to prospective investors. It is either executed as a bipartite agreement between the Fund and the Distributor or in some cases as a tripartite agreement between the Fund, Investment Management Company and the Distributor. The commercial arrangement between the fund and the distributor is based on marketing commissions. The principal terms of the distributor agreement would comprise of the following:

- Roles and Responsibilities of the parties to the agreement
- Rights and Obligations
- Indemnity clause
- Considerations/ Commissions
- Distribution of Commissions
- Penal actions in case of non-fulfilment of performance clause
- Arbitration

Since AIF distributorship is captured not just by the general principles under the Indian Contract Act, 1872 but is also regulated by the distributorship agreement, the performance of distributor duties and responsibilities is to be structured carefully and executed well to prevent penalties, arbitration and legal implications.

13.4 Preparation of Distribution Pitch

A good AIF sales pitch must consist of marketing literature including a well-formulated and compelling Investor Presentation that analyses the fund/ scheme being marketed in all areas that affect investor interests, highlights the features, commercial terms and risks of the scheme and provides guidance on how the particular scheme is a good fit for the investor. The investor presentation should be prepared after a complete analysis of the PPM issued by the Investment Manager, in particular the key disclosures in the PPM. The key components of an investor presentation should desirably include the following information:

- Distributor introduction and credentials
- History and track record of the AIF / scheme
- Details of Sponsor, Sponsor Commitment and Continuing Interest
- Particulars of the Investment Management Team and their credentials
- Current and previous performance of the Fund / Scheme
- Fund Structure, Key appointees, governance mechanisms
- Particulars of the present investment opportunity – scheme objectives, target corpus, commitments made, investment strategy, tenure, investment requirements
- Management Fees and Expenses chargeable to the Fund

- Tax treatment of product returns, key regulatory provisions affecting the product
- Key risk factors – these should be extracted from the detailed disclosures provided in the PPM. (*A list of these risk factors is provided in the Annexure to Chapter 6.*)
- Investor eligibility requirements
- Investment Process Flow
- Capital Commitment, drawdown, investment period, first close/ final close
- Additional returns, if any; catch up, if any
- Co-investment, MFN terms, if any
- Hurdle rate fund distributions as envisaged from the AIF
- Fund Reporting system envisaged
- Distributor Product Analysis and Recommendations
- Distributor services and Sales Pitch

The distribution kit should consist of the following information –

1. Copies of Fund Constitution and SEBI registration documents
2. Private Placement Memorandum issued by the AIF / Investment Manager
3. Distributor's Investor Presentation
4. Key Disclosure Statement extracted from the PPM
5. KYC documentation requirements and Forms for different constitutional requirements of investors
6. Note on FATCA requirements, where applicable
7. Expert opinions, if any
8. Key timelines
9. Essential approvals, if any, required for the investment
10. FAQs on the scheme, AIF, Investment Manager, investment process, investor eligibility, tax and regulatory aspects, scheme evaluation, risk profiling and selection.
11. Co-ordinates of key officials and relationship managers from the distributor's office.

13.5 Scope of Distribution Services (Pre and Post)

Distributor services are the key differentiators to establish the distributor's activity leadership and build impressive client profile and fund house relationships. The key elements of distributor services are listed below –

Pre-Commitment Services/ Activities

1. Engagement with investment managers and fund houses to obtain information on new fund/ scheme launches.

2. Engagement with Investors, wealth managers, portfolio managers, family offices, institutional fund houses, representative offices of foreign investors, organising investor meets, closed-door marketing launches.
3. Preparation of Presentation Pitches and Distribution Kits.
4. Making Presentation Pitch in initial meetings with investors.
5. Soliciting investor interest for deeper engagement on investment opportunity.
6. Providing the distribution kit to investors, explaining the key disclosures and risk factors, product fit and exploring the additional requirements of investors, advising on scheme selection based on product and risk profile and investor fit.
7. Compiling additional information requirements for investors and procurement of such information from the AIF / Investment Manager.
8. Facilitating Fund Due Diligence by investors.
9. Seeking consent for capital commitment.
10. Assisting/ liaison in the transaction process and paperwork / documentation.

Post-Commitment Services/ Activities

1. Liaison with investor office / AIF / manager offices for co-ordination on drawdown notices, transfer of funds and incidental processes connected with each drawdown transaction and paperwork.
2. Contact point for any support with respect to investor's requirements such as receipt of periodic reporting from the Investment Manager, meetings held by the manager with investors and incidental procedural requirements.
3. Assistance in forwarding, liaisoning on investor requirements to Investment Manager / AIF with regard to capital commitment, drawdowns, co-investments, MFN requests, fund performance, exits etc., and related investor grievances.
4. Marketing follow-on funds and associated activity.

13.6 Client Confidentiality and Data Privacy at Distributor Level

The Distributors Agreement signed between the Category I AIF/ Category II 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 I AIF/ Category II 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 I AIF/ Category II AIF, deemed to be owned by the fund. Sharing of such data would result in a breach of data privacy and confidentiality, resulting in suitable penalties and remedies as mentioned in the contract signed between the Category I AIF/ Category II 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 any 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.

13.7 Prohibit Fraudulent and Unfair Trade Practices

Distributors of Category I AIF/ Category II AIF 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 are 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 I AIF/ Category II AIF 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 I AIF/ Category II 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 (PAN) of the recipient.

Distributors should not follow unfair practices such as extending Pass-backs to investors, who subscribe to units of a Category I AIF/ Category II 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.

When providing their distribution services, Distributors should abstain from assuring returns to the investors, in any Category I AIF/ Category II AIF. They should be conversant with key provisions of PPM disclosures made by the Category I AIF/ Category II AIF, such as Investment Strategy, Fee Structure and key terms of the Contribution Agreement to be signed by an investor and the Category I AIF/ Category II 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.

13.8 Prohibit Conflict of Interest

Distributors should observe high standards of ethics, integrity and fairness in its dealings with clients, inter-alia including Investors, Category I AIF/ Category II AIF and its investment manager 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 I AIF/ Category II 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 I AIF/ Category II 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 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. 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.

Distributors should not follow unfair practices such as extending Pass-backs to investors, as this represents an inherent conflict. Further, Category I AIF/ Category II 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 I AIF/ Category II 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 I AIF/ Category II AIF 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 I AIF/ Category II 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.

13.9 Distributor Good Practices

Good business practices in AIF distributorship activity are necessary to establish credibility, trust, reputation and global standards of excellence that would also benefit the distribution house immensely in reaching leadership position in the industry eco-system. Good practices also help in meeting the regulatory intent of the AIF Regulations in serving the best interests of investors and establishing the industry on a firm footing. The main focus areas for establishing good practices are enlisted as follows:

MODEL GOOD PRACTICES FOR AIF DISTRIBUTORS

1. Consider investor's interest as paramount and take necessary steps to ensure that the investor's interest is protected adequately.

2. Adhere to the spirit of the AIF Regulations, compliance with the provisions of the Regulations, circulars and rules issued thereunder from time to time and the provisions of the Distributor Agreement related to distributors, selling, distribution and marketing practices. Be fully conversant with the key provisions of the Scheme PPM as well as the operational requirements thereof.

3. Comply with regulations as may be applicable from time to time in preparation of sales, promotional or distributor pitches with regard to the private offers of AIF products and ensure that these are not made available to unintended persons. Provide full and latest information of the AIF/ scheme / Investment Manager to investors in the form of additional information to the extent as may be required.

4. Highlight risk factors of each scheme, desist from misrepresentation and exaggeration and urge investors to go through the PPM and all associated documents before deciding to make investments.

5. Disclose to the investors all material information including Hurdle Rate, Management Fees, Additional Return if any, Catch-up if any, Expenses chargeable to the Fund and those that are borne by the Investment Manager.

6. Abstain from indicating or assuring returns in AIF schemes unless it's a pure debt scheme with assured returns as explicitly provided in the PPM.

7. Maintain necessary infrastructure to support the distribution activity in maintaining high service standards to investors, and ensure that critical operations such as forwarding documents and other paperwork to AIF / Manager / Custodian and dispatch of performance reports and intimation regarding draw down, closing, investor meetings and other important matters from time to time.

8. Distributors shall keep investor's interest and suitability to their wealth management needs as paramount and never base their recommendations of a scheme to the investor on their own pecuniary interests.

9. Distributors shall not undertake commission driven malpractices/ mis-selling such as:
    i. Recommending inappropriate schemes solely because the AIF is offering higher distribution commissions there from.
    ii. Pushing higher risk schemes to investors and influencing inappropriate decision-making.
    iii. Omission of material facts or obfuscating the decision-making process by misleading investors about the scheme.

10. Abstain from bad propaganda about competitor AIFs that the distributor is not representing. Ensure that comparisons, if any, are made with similar and comparable AIFs and schemes based on adequate information.

11. Distributors shall keep themselves abreast with the latest developments relating to the AIF Industry as also changes in the Fund / Investment Manager's office / Sponsor and scheme related developments like changes in fundamental attributes, changes in controlling interest, exit of key executives, adverse developments and other material aspects and deal with the investors appropriately having regard to the up to date information.

12. Maintain absolute data privacy and client confidentiality with respect to investor details, deals and transactions.

13. Distributors shall not rebate their commissions back to investors and abstain from attracting investors through expensive gifts and other forms of gratification.

14. To protect the investors from potential fraudulent activities, distributors should take reasonable steps to ensure that their own staff are assisting in the documentation and KYC process and not allow the paperwork to be outsourced or handled by a third party. Distributors should abstain from filling wrong / incorrect information or information of their own or of their employees, officials or agents as those of the investor even if so requested by the investor. Be diligent in attesting / certifying investor documents and performing In-Person Verification (IPV) of investors for the KYC process in accordance with prescribed guidelines. Distributor should abstain from tampering in any way with investor details provided in the documentation.

15. Extend complete co-operation to AIF, Investment Manager, Investor's office, SEBI or other regulatory authorities, due diligence agencies (as applicable) in providing requisite information, assisting in their requirements and regulatory compliance and matters connected thereto.

16. Provide all documents of its investors to tax authorities / enforcement agencies in terms of the Anti-Money Laundering / Combating Financing of Terrorism requirements, including KYC documents / Power of Attorney / contribution agreement(s), etc. as may be required by the AIF / Investment Manager / Statutory authorities from time to time.

17. Adhere to guidelines or other requirements (statutory or voluntary) as may be prescribed from time to time related to distributors, selling, distribution and marketing practices by industry associations.

18. Intimate the AIF / Investment Manager / Investors / Regulatory authority as applicable any changes in the distributor's status, constitution, address, contact details or any other information provided at the time of obtaining AIF distributorship.

19. Observe high standards of ethics, integrity and fairness in all its dealings with all parties – investors, AIF/ Investment Manager, Custodians and other service providers to them respectively or any related external agencies such as law firms, due diligence agencies etc. Render at all times high standards of service, exercise due diligence, and ensure proper care. Desist from practices that would involve conflict of professional interest or put investor interests in jeopardy. Do not indulge in fraudulent or unfair trade practices of any kind while selling AIF schemes either to domestic or offshore investors. Direct or indirect false or misleading statements, concealing or omitting material facts of the scheme, concealing associated risk factors of the schemes or not taking reasonable care to ensure suitability of the scheme to the investor will be construed as fraudulent / unfair trade practice under law.

20. Distributors shall have the organisational infrastructure and bandwidth to address investor grievances, assist in resolving them with suitable liaison with the AIF / Investment Manager / Custodian or other appropriate agency and if necessary help them in registering their complaint with SEBI. If the grievance relates to a flaw in the service of the distributor, such complaints shall be addressed expeditiously to the satisfaction of the investor.

Sample Questions: Chapter 13

1. One of the key provisions of a distributor agreement is ________________.

a. the role of the distributor in AIF investment strategy

b. the quantum of risk to be assumed by the AIF

c. the applicability of the SEBI (AIF) Regulations 2012 to the fund

d. the commercial understanding with the distributor

2. A key component of the investor presentation for a Category I or II AIF is ________.

a. the credit rating of the AIF

b. the credit rating of the instrument for subscription

c. fund structure, key appointees and governance mechanisms

d. the financial arrangements to leverage at fund level

3. One of the elements of a distribution kit is __________.

a. key timelines

b. the latest economic survey of the RBI

c. latest audited balance sheets of investee companies

d. banker references for the custodian of the fund

4. One of the reasons why distributors need to understand Category I and II AIF products better is because they are comparatively illiquid. State whether True or False.

a. True

b. False

5. One of the distributor good practices is to identify funds that provide minimum guaranteed return that meets the hurdle rate of the investor. State whether True or False.

a. True

b. False