

THE ULTIMATE  
**ALTERNATIVE  
INVESTMENT FUNDS  
GUIDE**  
— 2026 —

A Practitioner's Handbook for AIFs

BY

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## ABOUT THE AUTHOR

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Sagar Shah is the Founder of **Elite Valuation**, an independent valuation and boutique advisory firm serving clients across India. He brings **15 years of professional experience**, including **9 years at Ernst & Young (EY)**, where he served large Indian and multinational corporations across valuation, tax, regulatory advisory, and transaction structuring.

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### Core Expertise

- Designing ESOP Schemes, advising on tax optimization and implementation
- Valuation of companies and businesses across industries and size
- Intangible asset valuation: Trademark, Copyright, Brand, Software, License
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- M&A advisory, international tax, transfer pricing, cross-border transactions
- Financial due diligence & analytics, BRSR, and FEMA compliance
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### Our AIF Services

**AIF Portfolio Valuation:** Valuation of AIF portfolio companies for NAV computation, investor reporting, regulatory compliance, fund audit support, and periodic fair value assessment using DCF, market multiples, VC method, PE method, and other suitable valuation methodologies.

**AIF Registration & Structuring Advisory:** Advisory on AIF category selection, trust deed structuring, sponsor and investment manager requirements, PPM preparation, SEBI registration process, scheme structuring, and key regulatory milestones.

**Tax Structuring for AIFs:** Analysis of pass-through tax treatment for Category I and Category II AIFs, fund-level taxation for Category III AIFs, investor-level tax implications, TDS obligations, surcharge impact, AMT considerations, and distribution structuring.

**Investor Due Diligence & PPM Review:** Review of placement memoranda, investment strategy, fee structure, risk factors, governance framework, conflict of interest provisions, valuation policy, exit terms, and compliance architecture to help investors make informed allocation decisions.

**SEBI Compliance & Reporting Support:** Assistance with AIF regulatory filings, SEBI reporting, annual investor reports, material change filings, compliance calendar preparation, fund-level disclosures, FATCA and CRS coordination, and ongoing regulatory support.

**Independent Valuation Certificates:** Independent valuation certificates for unlisted portfolio companies, AIF portfolio fair value reporting, NAV support, investor reporting, regulatory submissions, fund audit requirements, and transaction-specific valuation documentation.

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*"A well-structured AIF requires more than fundraising. It requires the right category, the right governance, the right valuation framework, and the right compliance architecture. Get the structure right before the capital is deployed."*

*Sagar Shah, CA | CS | Registered Valuer*

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# TABLE OF CONTENTS

## **Section 1: The AIF Landscape in 2026**

Chapter 1: Background & Evolution of AIFs in India

Chapter 2: SEBI AIF Regulatory Framework

## **Section 2: Understanding AIF Structures & Categories**

Chapter 3: Categories of AIFs, A Deep Dive

Chapter 4: Structure & Constitution of an AIF

Chapter 5: Role of the Investment Manager

## **Section 3: Fund Operations & Investment Lifecycle**

Chapter 6: Fundraising, Capital Commitments & Drawdowns

Chapter 7: Investment Strategy & Portfolio Management

## **Section 4: Tax, Compliance & Reporting**

Chapter 8: Taxation of AIFs, Category-Wise Analysis

Chapter 9: Compliance, Reporting & Disclosure

## **Section 5: Valuation, Terminology & Practical Assessment**

Chapter 10: Valuation of AIF Portfolios

Chapter 11: Key Terminologies & Concepts Decoded

Chapter 12: Pros, Cons & Suitability Assessment

## **Conclusion**

Working With an AIF & Fund Valuation Expert

## SECTION 1: THE AIF LANDSCAPE IN 2026

# Chapter 1: Background & Evolution of AIFs in India

India AIF Industry Snapshot as referenced in the guide	1,849 registered funds	Rs. 15.74 lakh Cr cumulative commitments	Rs. 6.45 lakh Cr net investments
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## 1.1 The Pre-2012 Landscape: A Regulatory Vacuum

Before 2012, India's pooled investment vehicle landscape was fragmented, largely unregulated, and heavily informal. Venture capital funds (VCFs), private equity funds, hedge funds, and real estate funds operated under a patchwork of guidelines, SEBI's VCF Regulations 1996 governed a narrow category of funds, while most other pooled vehicles existed in a grey zone. Many sophisticated pooled structures operated as portfolio management services (PMS) or through offshore structures, often in jurisdictions such as Mauritius and Singapore, to access Indian capital markets.

The absence of a comprehensive domestic framework had significant consequences. Domestic investors who wished to participate in private equity, infrastructure, or early-stage investments had no standardised, regulated product to access. Fund managers lacked regulatory clarity on their obligations, disclosures, and permissible activities. SEBI, as the capital markets regulator, had limited visibility into the aggregate size, leverage, and risk profile of India's alternative investment ecosystem.

This regulatory vacuum was not a minor inconvenience, it was a structural gap that constrained the development of India's alternative asset class. Institutional investors such as pension funds, insurance companies, and family offices were reluctant to commit capital to unregulated vehicles. Foreign institutional interest in Indian alternatives was hampered by the lack of a recognised, internationally-benchmarked framework.

### KEY INSIGHT

*We observed firsthand, in our advisory practice, that fund managers attempting to structure domestic pooled vehicles before 2012 often had to resort to complex multi-layered structures, offshore holding companies, back-to-back loans, and offshore trust arrangements, just to achieve what a simple domestic AIF structure now accomplishes within a clear regulatory boundary. The introduction of the AIF framework eliminated much of this structural complexity and the associated costs and risks.*

## 1.2 The Birth of the AIF Framework: SEBI AIF Regulations, 2012

SEBI introduced the SEBI (Alternative Investment Funds) Regulations, 2012 (hereinafter referred to as 'AIF Regulations') on May 21, 2012, through Gazette Notification No. SEBI/LAD-NRO/GN/2012-13/10. This landmark regulation was the product of an extensive consultation process and drew heavily from the regulatory frameworks of developed markets, particularly the UK's AIFMD (Alternative Investment Fund Managers Directive) and the US's Dodd-Frank Act provisions relating to private fund advisers.

The AIF Regulations introduced a three-tier category system that has since become the defining architecture of India's alternative investment landscape. Category I funds were designed to channel capital toward economically productive areas, early-stage companies, infrastructure, SMEs, and social ventures. Category II was conceived as a broad 'catch-all' for funds not falling under Categories I or III, principally encompassing private equity, debt, and real estate funds. Category III captured sophisticated strategies involving leverage, short-selling, and complex derivatives, essentially, India's version of a hedge fund framework.

The minimum corpus requirement was set at Rs. 20 crore for most AIF schemes, signalling that the AIF structure was intended for sophisticated, institutional capital rather than retail participation. The standard minimum commitment per investor remains Rs. 1 crore, with prescribed exceptions such as Rs. 25 lakh for employees or directors of the AIF or its manager, Angel Fund participation under the accredited investor framework, and Large Value Funds for Accredited Investors (LVF-AI) requiring a higher minimum commitment of Rs. 25 crore per accredited investor.

#### **PRO TIP**

*When comparing the AIF framework to its 2012 predecessors, the single most important conceptual shift is the movement from activity-based regulation to entity-based regulation. Under VCF Regulations 1996, the regulator focused on what the fund invested in. Under AIF Regulations 2012, SEBI focuses on the fund entity itself, its registration, its manager, its governance, and its disclosure obligations, regardless of the specific assets held. This shift enables far greater flexibility in investment strategy within each category.*

### **1.3 Key Amendments: A Journey of Refinement (2012-2026)**

Since 2012, the SEBI AIF Regulations have undergone numerous amendments, each responding to market feedback, emerging risks, or policy imperatives. Some of the most consequential milestones include the following.

In 2013 and 2014, SEBI introduced clarifications on valuation norms, the treatment of unlisted securities, and the applicability of the regulations to foreign funds with India-focused strategies. The concept of 'angel funds' was introduced as a sub-category under Category I to provide a regulated structure for angel investing, which had previously operated entirely informally.

In 2015-2016 and in later amendments, SEBI progressively strengthened investment manager eligibility, governance, key investment team disclosures, experience and certification requirements, and conditions for investments by one AIF in units of another AIF. These changes collectively raised the bar for manager quality and reduced the risk of regulatory arbitrage.

The period 2017-2020 saw particularly significant amendments. SEBI introduced the framework for 'Large Value Funds for Accredited Investors' (LVF-AI), which offered a relaxed regulatory regime for funds accepting investments exclusively from SEBI-accredited investors committing above a threshold amount. This was a forward-looking regulatory innovation that acknowledged the sophisticated nature of large institutional capital and the reduced need for retail-style protections in that context.

From 2021 to 2026, SEBI's amendments have focused on three key themes: (a) improving transparency and standardisation of disclosures to investors; (b) regulating co-investment through the introduction of a specific co-investment framework; and (c) strengthening governance requirements, particularly around investment committees, conflict of interest policies, and independent valuers. SEBI also introduced important amendments relating to the appointment of custodians and the mandatory use of SEBI-registered debenture trustees for AIFs investing in debt securities.

Year	Key Milestone	Regulatory Impact
2012	SEBI AIF Regulations introduced	Three-category framework established
2013	Angel Fund sub-category introduced	Organised angel investing enabled
2017	LVF-AI framework introduced	Relaxed regime for accredited investors
2021	Standardised PPM and disclosure/reporting framework strengthened	Greater investor transparency

Year	Key Milestone	Regulatory Impact
2023	Independent valuer and portfolio valuation framework strengthened	NAV integrity reinforced
2025	Angel Fund reforms and CIV co-investment framework notified	Accredited investor framework and formal co-investment structure strengthened
2026	AIF Master Circular, regulatory reporting revisions and fast-track PPM processing	Current compliance architecture updated

Table 1.1: Key Milestones in the Evolution of AIF Regulations in India

## 1.4 The AIF Industry Today: Scale and Significance

As of early 2026, India's AIF industry has grown into one of the most dynamic segments of its financial ecosystem. From fewer than 50 registered AIFs in 2012-13, the industry had grown to 1,849 registered funds as of 31 March 2026, with cumulative commitments of approximately Rs. 15.74 lakh crore and net investments of about Rs. 6.45 lakh crore as of 31 December 2025 (per SEBI data), a compound annual growth rate of nearly 30% over the preceding five years. The industry has evolved from a niche, largely domestic phenomenon into a globally integrated asset class that attracts significant foreign capital.

Category II funds, primarily comprising private equity and debt funds, continue to dominate the AIF landscape by both number and committed capital. Category III funds, while fewer in number, represent the highest complexity and regulatory scrutiny. Category I funds, though the smallest by aggregate corpus, hold strategic importance given their role in channelling capital toward venture capital, social enterprise, and infrastructure development.

### KEY INSIGHT

*What strikes us most about the AIF industry's growth trajectory is not just the numbers, it is the quality of the capital. India's AIF ecosystem today includes participation from sovereign wealth funds, global institutional LPs, domestic insurance companies, pension funds, and ultra-high-net-worth family offices. This diversification of the investor base has fundamentally improved the stability and depth of India's alternative investment market. We expect this trajectory to continue as India's capital markets mature and as SEBI continues to refine the regulatory architecture.*

## SECTION 1: THE AIF LANDSCAPE IN 2026

# Chapter 2: SEBI AIF Regulatory Framework

## 2.1 The Governing Statute and SEBI's Authority

The SEBI (Alternative Investment Funds) Regulations, 2012, derive their authority from the Securities and Exchange Board of India Act, 1992 (SEBI Act). Section 11 of the SEBI Act confers on SEBI the power to regulate and develop the securities market, protect investor interests, and promote orderly growth of the securities market. The AIF Regulations are issued under Sections 11(1), 11(2)(h), and 30 of the SEBI Act, giving them full statutory force.

Every entity seeking to pool capital from investors for investing in accordance with a defined investment policy must register with SEBI as an AIF, unless specifically exempted. The requirement covers trusts, limited liability partnerships (LLPs), and bodies corporate. Regulation 3 of the AIF Regulations is categorical: no person shall act as an AIF or launch schemes without obtaining registration from SEBI.

## 2.2 Registration Requirements and Eligibility

An entity seeking registration as an AIF must file an application with SEBI in the specified format, along with the prescribed application fee. SEBI evaluates the application on multiple parameters, the track record and net worth of the sponsor, the qualifications and experience of the investment manager, the investment strategy and policies, and the governance structure proposed for the fund.

Key eligibility criteria for AIF registration include: the investment manager must be a body corporate or LLP with the prescribed minimum net worth, currently Rs. 5 crore for Category III and Rs. 3 crore for Categories I and II; the key investment team must satisfy the prescribed experience and certification requirements, including at least one key personnel meeting the applicable SEBI-specified experience and NISM certification requirement, unless a specific exemption applies; and the fund's proposed minimum corpus must meet the prescribed threshold of Rs. 20 crore, with separate treatment for Angel Funds and LVF-AI schemes.

### *PRO TIP*

*A common misconception among first-time AIF promoters is that SEBI registration is a one-time formality. In practice, SEBI's oversight is continuous. Any material change to the fund's structure, investment strategy, key personnel, or governance requires prior intimation or approval from SEBI. We advise all fund sponsors to build a dedicated compliance function from day one, not as an afterthought once the fund is fully operational.*

## 2.3 The Private Placement Memorandum (PPM)

The cornerstone of AIF investor documentation is the Private Placement Memorandum (PPM). The PPM is a comprehensive offering document that sets out, in standardised format prescribed by SEBI, all material information about the fund that an investor would need to make an informed investment decision. SEBI introduced standardised PPM formats in 2021 through a circular, significantly reducing the variability in information quality that had previously existed across fund offerings.

2026 update: SEBI operationalised a fast-track mechanism for processing placement memoranda of eligible AIF schemes filed with SEBI through circular dated 30 April 2026. Fund managers should evaluate eligibility for the fast-track route at the structuring stage because it can materially affect launch timelines.

The PPM must disclose the investment strategy and objectives, the categories of permissible investments and any restrictions, the fee and expense structure, the risk factors, the governance framework including the investment committee, conflict of interest policies, the performance track record of the manager (if any), the exit and liquidity provisions for investors, and the tax treatment of income at the fund and investor levels.

SEBI mandates that the PPM be filed with SEBI prior to commencement of fundraising. Any material modification to the PPM generally requires prior investor consent at the threshold prescribed under the AIF Regulations, applicable SEBI circulars and the fund documents, commonly two-thirds of investors by value for specified changes, followed by filing or intimation to SEBI as applicable. This requirement underscores the bilateral nature of the AIF contract: the PPM is not merely a marketing document but a binding representation from the manager to its investors.

#### KEY INSIGHT

*We have reviewed hundreds of PPMs across Category I, II, and III AIFs in our advisory practice. The single most frequent gap we observe is insufficient disclosure around the manager's conflict of interest policies, particularly in situations where the same manager or its affiliates run multiple parallel funds investing in the same sector. SEBI's standardised PPM format has improved baseline disclosure quality, but the substance of conflict of interest management still varies considerably across managers.*

## 2.4 SEBI's Oversight Mechanisms

SEBI exercises oversight over registered AIFs through multiple channels. Periodic compliance reports must be submitted by all registered AIFs through the SEBI intermediary portal. These reports include details of commitments raised, capital drawn, portfolio investments, investor demographics, and compliance certifications. SEBI may also conduct thematic inspections and targeted examinations of specific AIFs or investment managers when regulatory concerns arise.

In addition to periodic reporting, SEBI has the power to call for information, conduct on-site inspections, appoint auditors, and take enforcement action against AIFs and their managers for non-compliance. The penalties for regulatory violations can include suspension or cancellation of registration, monetary penalties under the SEBI Act, and referral for criminal prosecution in serious cases.

Regulatory Requirement	Frequency / Trigger	Filed With
AIF Regulatory Reporting (AAR/QAR)	As prescribed by SEBI under the March 2026 reporting circular	SEBI Intermediary Portal
Annual Report to Investors	Within 180 days of year-end	Investors
Material Change Disclosure	Before effecting specified material change	SEBI + investors, with prescribed investor consent where applicable
Key Investment Team / Key Personnel Change	As prescribed under AIF Regulations, circulars and PPM	SEBI and investors, as applicable
Valuation Report / NAV Reporting	At least semi-annual or as applicable by category, PPM and SEBI requirements	Investors and other recipients as applicable
Audited Financial Statements	Annual	Investors, SEBI or other authorities as applicable
Winding Up / Dissolution Reporting	Upon winding up, liquidation or dissolution period events	SEBI and investors

Table 2.1: Summary of Key AIF Regulatory Reporting Requirements

## 2.5 SEBI's Investor Protection Provisions

A central pillar of the AIF regulatory framework is investor protection. SEBI requires that the investment manager execute a separate contribution agreement with each investor, setting out the investor's rights, obligations, and the fund's governance architecture. The PPM must clearly disclose all material risks, and the investment manager cannot make representations about expected returns that are not grounded in documented analysis.

SEBI also mandates a continuing interest requirement for the sponsor or manager, often referred to as skin-in-the-game, to align the sponsor or manager economically with investors. The continuing interest must be maintained in the prescribed manner throughout the fund's life and cannot be met through waiver of management fees. The exact requirement differs by category, for example 2.5% of corpus or Rs. 5 crore, whichever is lower, for Category I and II AIFs; 5% of corpus or Rs. 10 crore, whichever is lower, for Category III AIFs; and a separate lower threshold for Angel Funds.

**PRO TIP**

*One of the most underappreciated investor protection features in the AIF Regulations is the mandatory key person provision. If the designated key investment professionals leave the fund manager, the fund enters a 'key person event', triggering mandatory investor communication, a defined cure period, and in some cases, investor redemption rights. We recommend investors carefully review the key person provisions in the PPM before committing capital, as the quality and continuity of the investment team is the most critical determinant of fund performance.*

## SECTION 2: UNDERSTANDING AIF STRUCTURES & CATEGORIES

# Chapter 3: Categories of AIFs, A Deep Dive

## 3.1 The Three-Category Architecture

The AIF Regulations establish three distinct categories of funds, each defined by its investment mandate, permissible instruments, leverage restrictions, and tax treatment. This categorical architecture is not arbitrary, it reflects a deliberate policy choice to align regulatory treatment with the economic and social function of each type of fund. Understanding the distinction between categories is the first and most fundamental step in AIF literacy.

AIF Category Architecture, Overview

Category I	Category II	Category III
Invests in start-ups, SMEs, infrastructure, social ventures. Perceived as economically productive. Positive regulatory treatment.	PE funds, debt funds, real estate funds. Neither Category I nor III. No specific incentives or restrictions on leverage.	Employs complex strategies including leverage and derivatives. Highest regulatory scrutiny. Fund-level taxation.

## 3.2 Category I AIFs, Catalysts for Economic Growth

Category I funds are defined under Regulation 3(4)(a) of the AIF Regulations as funds that invest in start-up companies or early stage ventures or social ventures or SMEs or infrastructure or other sectors or areas considered by the Government or regulators as socially or economically desirable. The defining characteristic of Category I is that the fund's investment mandate is directed toward categories of investment that attract positive regulatory or policy treatment.

### 3.2.1 Venture Capital Funds (VCFs)

VCFs under Category I invest primarily in equity or equity-linked instruments of unlisted companies that are in early growth stages. The VCF framework under AIF Regulations was designed to create a successor structure to the older SEBI VCF Regulations 1996, which were repealed when the AIF framework came into force. VCFs typically employ a ten-year fund life with a three to four year investment period, followed by a harvesting phase.

### 3.2.2 Angel Funds

Angel Funds represent a uniquely Indian regulatory innovation, a sub-category under Category I specifically designed for angel investing. Following the SEBI (Alternative Investment Funds) (Second Amendment) Regulations, 2025 (notified 9 September 2025) and the accompanying circular dated 10 September 2025, the framework was substantially overhauled. An Angel Fund may now raise capital only from accredited investors (the earlier "angel investor" net-worth concept has been replaced), and must onboard at least five accredited investors before its first close, which must be declared within twelve months of SEBI taking the placement memorandum on record. The earlier minimum corpus requirement of Rs. 5 crore and the minimum commitment of Rs. 25 lakh per angel investor have both been removed. The permitted investment in a single investee company has been revised to a range of Rs. 10 lakh to Rs. 25 crore (from the earlier Rs. 25 lakh to Rs. 10 crore), and each investment must have participation from at least two accredited investors. Existing angel funds have a transition period up to 8 September 2026 to align with the new regime.

### 3.2.3 SME Funds

SME Funds invest primarily in equity or quasi-equity instruments of small and medium enterprises, a segment that has historically faced significant capital access constraints despite contributing

meaningfully to India's GDP and employment. SME Funds serve as a structured vehicle for directing institutional capital toward this underserved segment.

### 3.2.4 Social Venture Funds

Social Venture Funds (SVFs) deploy capital into companies that pursue social objectives alongside financial returns, enterprises operating in sectors such as affordable healthcare, clean energy, education, and rural livelihoods. SVFs may accept a below-market return on capital in exchange for measurable social impact, provided investors are fully informed of this trade-off in the PPM.

### 3.2.5 Infrastructure Funds

Infrastructure Funds invest in infrastructure projects or companies in sectors such as roads, ports, power, water, and telecom. These funds often benefit from government policy support, viability gap funding, or concessional financing from development finance institutions. Infrastructure Funds may have longer gestation periods and carry periods compared to other Category I vehicles.

#### KEY INSIGHT

*We frequently advise fund sponsors on the choice between Category I and Category II classification. The decision is not purely regulatory, it has significant tax implications. Category I funds enjoy pass-through tax treatment, meaning income is taxed in the hands of investors at their applicable tax rates rather than at the fund level. This can be a meaningful advantage for domestic investors with lower tax rates. However, the Category I classification also comes with investment mandate restrictions that may limit strategic flexibility. We recommend a careful analysis of both dimensions before choosing a category.*

## 3.3 Category II AIFs, The Broad Middle Ground

Category II encompasses the broadest and most diverse set of fund strategies. Regulation 3(4)(b) defines Category II as funds that do not fall under Category I or III and do not undertake leverage or borrowing other than to meet day-to-day operational requirements. In practice, Category II includes private equity funds, debt funds, real estate funds, and fund of funds.

Private equity funds under Category II invest primarily in equity and equity-related instruments of unlisted companies with a view to value creation over a medium-to-long term investment horizon, typically three to seven years. Debt funds invest in structured debt instruments, NCDs, CPs, and other fixed-income securities of unlisted or listed companies. Real estate funds deploy capital into commercial or residential real estate projects, often through SPVs, and may include mezzanine or structured equity components.

#### PRO TIP

*A critical compliance point for Category II AIFs: while the regulations permit borrowing for 'day-to-day operational requirements,' SEBI has taken a strict view that this does not include leverage for investment purposes. Category II AIFs that wish to employ leverage at the portfolio company level (through back-leverage or subscription lines) must structure carefully to ensure that such arrangements do not constitute fund-level leverage. We recommend legal opinion on any such structures before implementation.*

## 3.4 Category III AIFs, Sophisticated Strategies

Category III is defined as funds that employ diverse or complex trading strategies and may employ leverage including through investment in listed or unlisted derivatives. This category is explicitly designed for hedge funds, long-short equity funds, PIPE (Private Investment in Public Equity) funds, and other strategies that employ short-selling, derivatives overlays, or significant leverage.

Category III AIFs may employ leverage in accordance with SEBI's prescribed conditions, including exposure and risk management requirements disclosed in the PPM and reported to SEBI. The practical regulatory position should be assessed against the latest SEBI Master Circular, the scheme's PPM and the applicable methodology for calculating leverage and exposure.

Feature	Category I	Category II	Category III
Investable Universe	Start-ups, SMEs, infrastructure, social ventures and other specified socially/economically desirable sectors	Private equity, debt, real estate, fund of funds and other strategies not falling under Category I or III	Listed or unlisted securities, derivatives and complex or diverse trading strategies
Fund-level Leverage	Not permitted, except temporary borrowing for permitted operational needs	Not permitted, except temporary borrowing for permitted operational needs	Permitted subject to SEBI leverage, exposure, risk management and disclosure requirements
Tax Treatment	Pass-through under Section 115UB for income other than business income	Pass-through under Section 115UB for income other than business income	Generally fund-level taxation
Custodian	Mandatory if corpus exceeds prescribed threshold, currently Rs. 500 crore, and otherwise as applicable	Mandatory if corpus exceeds prescribed threshold, currently Rs. 500 crore, and otherwise as applicable	Mandatory
Minimum Corpus	Rs. 20 crore, with separate Angel Fund framework	Rs. 20 crore	Rs. 20 crore
Typical Strategies	VC, Angel, SME, Social Venture, Infrastructure	PE, Debt, Real Estate, FoF	Hedge, PIPE, Long-Short, Derivatives

Table 3.1: Comparative Feature Matrix, AIF Categories I, II & III

## SECTION 2: UNDERSTANDING AIF STRUCTURES & CATEGORIES

# Chapter 4: Structure & Constitution of an AIF

## 4.1 Legal Forms: The Three Permitted Structures

Under Regulation 2(1)(b) of the AIF Regulations, an AIF may be established as a trust, a limited liability partnership (LLP), or a body corporate. The choice of legal form has significant implications for governance, flexibility, taxation, and investor rights. In practice, the overwhelming majority of Indian AIFs, estimated at over 90%, are structured as trusts. The trust structure's flexibility, speed of registration, and alignment with the distribution waterfall requirements of typical AIF arrangements make it the preferred choice.

### 4.1.1 Trust Structure

An AIF trust is governed by the Indian Trusts Act, 1882, and the terms of the trust deed executed between the settlor (typically the sponsor) and the trustees. The trust deed is the foundational constitutional document of the AIF, it defines the objects of the trust, the powers and obligations of the trustees, the governance framework, and the rights of beneficiaries (investors). In practice, the trust deed operates in conjunction with the PPM and the contribution agreement, together forming the complete contractual architecture of the fund.

A key advantage of the trust structure is that it is not a legal person in the strict sense (unless registered under the Registration Act), enabling pass-through tax treatment without the complications of a corporate entity's tax profile. The trust also provides flexibility in establishing multiple schemes under the same umbrella, with each scheme having its own investment mandate, investor pool, and expense structure.

### 4.1.2 LLP Structure

An AIF structured as an LLP is governed by the Limited Liability Partnership Act, 2008, and the LLP agreement. In an LLP structure, the investment manager typically acts as the designated partner responsible for management, while investors participate as limited partners whose liability is limited to their committed capital. LLP structures are more common in fund-of-funds or co-investment vehicle contexts, where the contractual flexibility of an LLP agreement offers certain advantages over a trust deed.

### 4.1.3 Body Corporate

A body corporate structure, typically a private limited company incorporated under the Companies Act, 2013, is the least common form for AIFs due to the additional regulatory and compliance overhead associated with corporate governance. However, certain specialised fund structures, particularly those with mandates that require a corporate entity (such as certain infrastructure holding structures), may use this form.

#### KEY INSIGHT

*We have helped structure both trust and LLP-based AIFs across Category I, II, and III strategies. Our strong preference, and the preference of most experienced fund counsel, remains the irrevocable trust structure. The trust deed, properly drafted, provides the clearest separation between the fund's assets and the manager's assets, the most robust investor recourse framework, and the cleanest pass-through tax profile. The LLP is useful in specific co-investment or parallel vehicle contexts, but should not be the default choice for a primary AIF vehicle.*

## 4.2 Key Constituents of an AIF

Regardless of the legal form chosen, every AIF involves a defined set of constituents, each with specific roles, responsibilities, and obligations. Understanding these roles is essential for both investors and regulators assessing the fund's governance architecture.

### 4.2.1 The Sponsor

The sponsor is the entity that establishes the AIF. In a trust structure, the sponsor is the settlor, the party who creates the trust by executing the trust deed and committing the initial seed corpus. SEBI requires the sponsor or manager to maintain a minimum continuing interest (skin-in-the-game) in the AIF, which must not be met through a waiver of management fees and must be maintained throughout the fund's life. Under Regulation 10(d) of the AIF Regulations, this continuing interest is at least 2.5% of the corpus or Rs. 5 crore, whichever is lower, for Category I and Category II AIFs; at least 5% of the corpus or Rs. 10 crore, whichever is lower, for Category III AIFs; and at least 2.5% of the corpus or Rs. 50 lakh, whichever is lower, for Angel Funds. This requirement ensures that the sponsor bears economic risk alongside investors.

### 4.2.2 The Investment Manager

The investment manager (IM) is the entity responsible for managing the AIF's investments. The IM must be registered with SEBI (as part of the AIF registration) and must meet the prescribed net worth and experience criteria. The IM makes all investment and divestment decisions (typically through an investment committee), manages the fund's relationships with portfolio companies and investors, and is responsible for regulatory compliance.

### 4.2.3 The Trustee(s)

The trustee has fiduciary obligations toward investors and must act in their best interests. The trustee's role has evolved significantly since 2012, with SEBI increasing trustee oversight responsibilities in successive amendments. The precise trustee obligations should be assessed against the latest AIF Regulations, SEBI Master Circular and, where relevant, any relaxations available for AI-only or LVF schemes.

### 4.2.4 The Custodian

For Category III AIFs, and for all AIFs with a corpus exceeding Rs. 500 crore, the appointment of a SEBI-registered custodian is mandatory. The custodian holds the fund's securities and cash in safekeeping, independently of the investment manager, providing an additional layer of investor protection. The custodian also plays a critical role in NAV computation, trade settlement, and corporate action processing.

### 4.2.5 Fund Administrator

While not separately regulated under the AIF Regulations, most AIF trusts appoint a fund administrator, a specialised service provider responsible for maintaining investor registers, processing capital calls and distributions, computing NAVs, and preparing periodic investor reports. The fund administrator acts as the operational backbone of the fund, ensuring accurate and timely processing of all investor transactions.

Constituent	Legal Role	Key SEBI Requirement
Sponsor	Establishes fund; settlor in trust structure	Continuing interest as prescribed by category
Investment Manager	Manages investments and compliance	Minimum net worth, experience and certification requirements
Trustee	Holds trust assets for beneficiaries	Trustee oversight as per AIF Regulations, trust deed and SEBI circulars

Constituent	Legal Role	Key SEBI Requirement
Custodian	Safekeeps securities and supports settlement/NAV controls	Mandatory for Category III and for AIFs crossing prescribed corpus threshold
Fund Administrator	Operational management, investor records and NAV support	Appointed by IM; not separately regulated under AIF Regulations
Statutory Auditor	Financial audit	Registered CA firm; annual audit mandatory

Table 4.1: Key AIF Constituents and Their Regulatory Requirements

### 4.3 Open-Ended, Close-Ended, and Semi-Open Structures

A critical structural choice in AIF formation is the fund's redemption and liquidity architecture. Close-ended AIFs have a fixed tenure (typically 5 to 10 years for PE funds, often extendable by one to two years), during which investors cannot redeem their units. This structure aligns well with illiquid investment strategies in private equity, infrastructure, and venture capital, where value creation occurs over extended time horizons.

Open-ended AIFs permit investor redemption at specified intervals (such as quarterly or semi-annually), subject to notice periods and potential redemption gates. Open-ended structures are more common in Category III funds, particularly those employing liquid strategies. Semi-open structures offer limited liquidity windows, for example, quarterly redemption options subject to an overall gate of 25% of NAV per quarter.

#### *PRO TIP*

*When evaluating an AIF's structure, investors should pay particular attention to the fund's side-pocket provisions. Side pockets allow the IM to segregate illiquid or stressed portfolio assets from the main fund portfolio, enabling redemptions on the liquid portion without being constrained by the illiquid assets. While side pockets protect redeeming investors from being advantaged at the expense of remaining investors (and vice versa), they can be complex to administer and value. We always recommend investors request a clear explanation of the fund's side-pocket policy before investing.*

## SECTION 2: UNDERSTANDING AIF STRUCTURES & CATEGORIES

# Chapter 5: Role of the Investment Manager

## 5.1 The Central Role of the Investment Manager

In the ecosystem of an AIF, the Investment Manager (IM) is the engine. While the sponsor creates the fund and the trustee provides legal stewardship, it is the investment manager who drives every substantive decision, from sourcing and evaluating investments to portfolio monitoring, exit execution, and investor communication. The quality of the IM is, without question, the most important determinant of long-term fund performance.

The IM must be constituted in a form permitted under the AIF framework, generally a body corporate or LLP, with the requisite net worth, qualified key personnel, relevant experience, and certification requirements. The IM is considered as part of the AIF's registration architecture with SEBI, unlike in some jurisdictions where the fund manager and the fund vehicle are separately registered.

## 5.2 Fiduciary Duties and Legal Obligations

The investment manager operates as a fiduciary to the AIF's investors. This fiduciary relationship imposes duties that go significantly beyond mere contractual obligations, they include the duty of loyalty (placing investor interests above the IM's own), the duty of care (making investment decisions with appropriate diligence), the duty of confidentiality, and the duty of disclosure (keeping investors informed of material developments).

Under Regulation 20 of the AIF Regulations, the investment manager must: act in a fiduciary capacity toward investors; not engage in market manipulation or insider trading; not engage in fraudulent or unfair trade practices; maintain proper accounts, records, and documents; and perform due diligence before making investments. SEBI has the power to inspect these records at any time.

### KEY INSIGHT

*From our experience advising both fund managers and investors, the tension between the IM's dual roles, as an investment decision-maker and as a fiduciary to investors, is most acute in conflict-of-interest situations. These arise when the IM manages multiple funds investing in similar sectors, when the IM or its affiliates participate in transactions alongside the fund (co-investments), or when the IM serves on the board of a portfolio company. We recommend that every AIF establish a formal conflict of interest policy with clear escalation and resolution procedures, and that this policy be disclosed fully in the PPM.*

## 5.3 The Investment Committee

All material investment and divestment decisions in an AIF are made through a formal investment committee (IC). The IC is the governance body through which the IM exercises its investment decision-making authority. SEBI's regulations and best practices require the IC to have a defined composition (typically including senior investment professionals and, in some cases, independent members), formal charter, quorum requirements, and decision-making procedures.

IC meetings must be documented through formal minutes, which serve as a contemporaneous record of the investment rationale, the information considered, the alternatives evaluated, and the basis for the decision taken. These minutes are critical for regulatory inspections, investor due diligence, and, in extreme cases, litigation. A well-maintained IC record is a hallmark of a professionally managed fund.

## 5.4 Key Person Provisions and Continuity

SEBI requires disclosure of the key investment team members in the PPM, and any change in the key investment team or key personnel must be handled in accordance with the AIF Regulations, SEBI circulars and the fund documents. A key person event should trigger prompt investor communication, SEBI intimation where required, and the cure or consent mechanism specified in the PPM. The exact suspension, replacement and exit rights depend on the PPM and applicable regulatory framework.

Investors have the right to exit the fund (with the exit rights as defined in the PPM) if a key person event is not remedied within the specified timeframe. This provision is a critical investor protection mechanism, recognising that investors in an AIF are, to a large extent, backing specific individuals rather than a generic investment strategy.

#### **PRO TIP**

*When conducting due diligence on an AIF, we recommend investors go beyond the formal key person provisions in the PPM and conduct informal reference checks on the key investment team. Ask the IM to describe specific investments, including failed ones, and the lessons learned. Assess the team's internal knowledge-sharing culture and whether the investment philosophy is truly institutionalised or concentrated in one or two individuals. A fund whose stated key person is also its only competent investment professional presents meaningful key person risk regardless of the formal contractual protections.*

## **5.5 Regulatory Compliance Responsibilities of the IM**

Beyond investment management, the IM bears primary responsibility for the AIF's regulatory compliance. This includes: timely filing of periodic reports with SEBI; ensuring the fund's investments remain within the permissible universe and within prescribed concentration limits; maintaining FATCA and CRS compliance for cross-border investors; overseeing the valuation process and ensuring independence of the valuer; managing related-party transaction approvals; and reporting any regulatory violations or material adverse events to SEBI within prescribed timelines.

The IM must also maintain a comprehensive compliance calendar and appoint a principal officer (compliance officer) responsible for regulatory oversight. SEBI inspections of AIFs often focus as much on compliance infrastructure as on investment performance, reflecting SEBI's view that process quality is a leading indicator of fund integrity.

<b>Responsibility</b>	<b>Frequency / Trigger</b>	<b>Regulatory Obligation</b>
Investment Decisions	Ongoing	Through IC or approved governance process with documented rationale
Regulatory Reporting to SEBI	AAR/QAR and event-based filings as prescribed	Mandatory via SEBI portal or prescribed mode
Annual Report to Investors	Annual	Within 180 days of financial year-end
Valuation of Portfolio	At least semi-annual, or more frequently where applicable	Independent valuation for unlisted/infrequently traded assets as applicable
FATCA/CRS Compliance	Annual and event-based	CBDT / OECD framework
Key Person / Key Team Event Notification	On occurrence	SEBI and investors as applicable under PPM and regulations
Material Change Approval	Before effecting specified change	Prescribed investor consent and SEBI filing/intimation as applicable

Table 5.1: Key IM Compliance Responsibilities and Timelines

## **5.6 IM Liability and Indemnification**

The investment manager is generally indemnified by the AIF against losses arising from good-faith investment decisions made within the scope of the PPM and applicable law. However, this indemnification does not extend to losses resulting from the IM's gross negligence, wilful misconduct, fraud, or breach of fiduciary duty. In practice, determining where the boundary between good-faith judgment and negligence lies is a complex factual and legal question.

Recent SEBI enforcement actions have demonstrated an increasing willingness to hold investment managers directly accountable for regulatory violations, with penalties extending to individual fund managers in cases involving insider trading, market manipulation, or deliberate misrepresentation to investors. This trend underscores the importance of a strong compliance culture within IM organisations.

#### **KEY INSIGHT**

*We have observed a significant shift in how Indian institutional LPs approach IM due diligence over the past five years. Earlier, due diligence was primarily financial, focused on the IM's track record, strategy, and return attribution. Today, leading institutional LPs spend considerable time assessing the IM's compliance infrastructure, ESG integration, cybersecurity protocols, and internal governance. We expect this trend to continue and accelerate, particularly as global institutional capital allocators impose increasingly sophisticated ESG and governance requirements on their Indian AIF allocations.*

## SECTION 3: FUND OPERATIONS & INVESTMENT LIFECYCLE

# Chapter 6: Fundraising, Capital Commitments & Drawdowns

## 6.1 Eligible Investors and Minimum Investment

AIFs are private placement vehicles, they may not make a public offering of units and are restricted to raising capital through private placements with sophisticated investors. The regulatory framework defines eligible investors broadly to include individuals, HUFs, family trusts, sole proprietorships, partnership firms, companies, body corporates, and institutional entities including banks, insurance companies, pension funds, and foreign institutional investors.

The standard minimum commitment per investor is Rs. 1 crore, except for employees and directors of the AIF or the investment manager, for whom a lower threshold of Rs. 25 lakh applies. For Angel Funds, following the September 2025 amendments, participation is restricted to accredited investors and the earlier Rs. 25 lakh minimum commitment per angel investor has been removed. Large Value Funds for Accredited Investors (LVF-AI) require a minimum commitment of Rs. 25 crore per accredited investor, in exchange for specified regulatory relaxations.

## 6.2 The Capital Commitment Mechanism

The foundational financial mechanism of a close-ended AIF is the capital commitment structure. Unlike a mutual fund where investors pay the full subscription amount upfront, an AIF investor makes a binding commitment to invest a specified amount over the fund's life, with actual capital deployed in tranches (called drawdowns or capital calls) as the IM identifies and executes investments.

The commitment amount is set out in the investor's contribution agreement and represents the investor's legally binding obligation. The IM may call capital (issue capital calls) as needed to fund investments, pay expenses, or maintain a defined reserve buffer. Investors who fail to fulfil a capital call within the specified notice period (typically 10 to 15 business days) are treated as defaulting investors and may face penalties, dilution of their interest, or forced transfer of their units.

### KEY INSIGHT

*The capital commitment mechanism creates a unique cash flow planning challenge for AIF investors, particularly individuals and family offices that do not have dedicated portfolio teams. We consistently advise our investor clients to maintain a dedicated liquidity reserve earmarked for AIF capital calls, and to avoid over-committing to AIFs relative to their liquid asset base. A common mistake is to commit capital based on projected near-term liquidity without accounting for the risk of unexpected expenses or market downturns that may compress available liquidity simultaneously with capital calls.*

## 6.3 Fund Closing Mechanics: First Close, Subsequent Closes, and Final Close

A close-ended AIF typically raises capital through a process of 'closes' rather than a single fundraise. The first close is the initial milestone at which the fund has raised sufficient committed capital to begin deploying investments, SEBI regulations permit deployment of capital after the first close. Investors who commit at first close benefit from early mover advantages but also bear the risk of a fund that may not achieve its target corpus.

Subsequent closes admit additional investors (and potentially admit existing investors' increased commitments) at later points in the fundraising period. Investors admitted at subsequent closes are typically required to pay an equalisation amount, a compensatory return calculated to ensure that

late-joining investors are economically equivalent to first-close investors, adjusted for returns earned on investments made between the first and subsequent closes. This prevents late investors from getting a 'free ride' on investments already made.

The final close marks the end of the fund's fundraising period, after which no new investors may be admitted. After the final close, the fund enters the investment period, typically three to four years for a close-ended PE fund, during which the IM actively deploys committed capital.

#### **PRO TIP**

*Equalisation at subsequent closes is one of the most technically complex aspects of AIF administration. The equalisation calculation involves computing a deemed return on the existing portfolio at the subsequent close date, charging late investors an amount equivalent to the return they would have paid if they had been first-close investors, and often involves a 'catch-up' mechanism on the performance fee. We recommend investors closely review the equalisation methodology described in the PPM, inaccurate or poorly designed equalisation can result in unintended economic transfers between early and late investors.*

## **6.4 Green Shoe Option**

Some AIFs include a 'green shoe option' in their PPM, the right to accept additional commitments beyond the target corpus, up to a specified maximum disclosed in the fund documents. The green shoe option provides the IM with flexibility to scale the fund if fundraising momentum is strong. The exact headroom, approvals and filings should be assessed under the PPM, SEBI registration terms, applicable placement memorandum format and latest SEBI requirements, rather than assuming a universal percentage cap.

## **6.5 Foreign Capital in AIFs: FPI, FVCI, and FEMA Considerations**

Indian AIFs may accept investments from foreign investors subject to the AIF Regulations, FEMA, the Non-Debt Instruments Rules, FPI Regulations where relevant, sectoral caps, beneficial ownership checks, KYC, AML, tax and reporting requirements. The route and treatment depend on the investor's status, the AIF category, the downstream investment strategy and whether the investment is treated as foreign investment in the AIF or requires downstream investment analysis. Foreign investment structuring should therefore be reviewed separately for each fund and investor class.

Foreign Venture Capital Investors (FVCIs) registered with SEBI enjoy a special investment regime that provides flexibility to invest in certain categories of unlisted companies and AIF units, subject to their investment conditions. The tax treaty between India and the investor's jurisdiction of residence is a critical consideration in structuring foreign investment into AIFs, particularly for Category III funds where fund-level tax applies.

Stage	Event	Key Implication
Pre-First Close	Fundraising, PPM distribution, investor diligence	No capital deployment permitted
First Close	Minimum viable corpus achieved	Deployment of capital may commence
Subsequent Close(s)	Additional investors / commitments admitted	Equalisation applies to late entrants
Final Close	Fundraising period ends	No new investors admitted after this point
Investment Period	Active capital deployment	Typically 3-4 years from final close

Stage	Event	Key Implication
Harvest / Realisation Period	Exit investments, distribute proceeds	Post-investment period
Winding Up	Final distributions, fund dissolution	SEBI reporting; trust dissolution

Table 6.1: Life Cycle of a Close-Ended AIF, Key Stages and Events

#### **KEY INSIGHT**

*We have seen a marked increase in the complexity of AIF fundraising structures in recent years, driven largely by the entry of global institutional LPs into the Indian market. These LPs bring rigorous LP Agreement templates from global PE markets, often insisting on MFN (Most Favoured Nation) clauses, LP Advisory Committee rights, ESG side letters, ERISA compliance certificates, and robust co-investment rights. Indian fund managers must build the legal and administrative capacity to accommodate these requirements, which often involves significant upfront legal cost but is essential for accessing high-quality institutional capital.*

## SECTION 3: FUND OPERATIONS & INVESTMENT LIFECYCLE

# Chapter 7: Investment Strategy & Portfolio Management

## 7.1 Investment Restrictions by Category

SEBI's AIF Regulations prescribe specific investment restrictions for each category, designed to align investment behaviour with the fund's stated purpose and risk profile. Category I AIFs must invest primarily in the designated sectors (start-ups, SMEs, infrastructure, social ventures) and are restricted from investing in other AIFs (except as specified). Category II AIFs face fewer investment restrictions but are prohibited from using fund-level leverage for investments. Category III AIFs may invest across listed and unlisted instruments and may employ leverage, but are subject to prescribed concentration limits.

## 7.2 Concentration Limits

SEBI mandates that an AIF not invest more than 25% of its investable corpus in a single investee company. This concentration limit is a portfolio risk management tool designed to prevent excessive single-company exposure that could impair the fund's overall return profile. For Category III AIFs, the limit is more stringent, 10% of investable corpus per single investee company.

Investable corpus for concentration limit purposes is defined as the total committed corpus minus the fund's estimated expenses for the remainder of the fund's life. This definition ensures that concentration limits are computed against the capital actually available for investment, rather than the gross committed amount.

### KEY INSIGHT

*In our portfolio management advisory engagements, we have seen cases where a fund's concentration limit compliance was technically maintained but economically meaningless, for instance, a fund with three portfolio companies each consuming close to 25% of investable corpus. While technically within the regulatory limit, this level of concentration presents significant portfolio risk. We recommend that IMs adopt internal concentration limits more stringent than the SEBI minimum, and that investors assess a fund's historical portfolio construction to understand the de facto concentration profile.*

## 7.3 Related Party Transactions

AIF regulations impose strict controls on related party transactions, investments in entities affiliated with the IM, the sponsor, or key personnel. Any investment in a related party entity requires prior approval of at least 75% of the investors by value (or the threshold specified in the PPM) and must be made at arm's length terms, supported by an independent valuation opinion.

Related party transactions must be disclosed in periodic investor reports, and the IM must maintain a register of related party transactions accessible to investors on request. SEBI inspections routinely scrutinise related party transaction records, given the heightened conflict of interest risk they present.

## 7.4 Co-Investment Framework

Co-investment refers to the practice of allowing AIF investors (or third parties) to invest directly alongside the AIF in a specific portfolio company, at the same valuation and terms as the fund. SEBI introduced a formal framework for co-investment vehicle (CIV) schemes through the SEBI (Alternative Investment Funds) (Second Amendment) Regulations, 2025 and the accompanying CIV circular dated 9 September 2025. This framework permits Category I and Category II AIFs to launch CIV schemes

exclusively for accredited investors, in addition to the pre-existing co-investment route available through SEBI-registered portfolio managers, and requires that co-investor terms not be more favourable than the AIF's, with identical exit timing. AIFs are expected to develop documented co-investment policies and to offer opportunities on a non-discriminatory basis.

The co-investment policy must address: the criteria for identifying co-investment opportunities; the allocation process and priority (AIF first, then co-investors); the fee and carried interest treatment for co-investors; and the governance rights of co-investors relative to the fund. A well-structured co-investment programme can significantly enhance an IM's ability to pursue larger transactions without exceeding concentration limits or straining the fund's capital reserves.

#### **PRO TIP**

*Co-investment rights are one of the most valuable concessions an AIF investor can negotiate, and they are increasingly being used as a competitive differentiator by fund managers seeking to attract large institutional LPs. However, investors must carefully assess the co-investment opportunity flow, what percentage of the IM's deals are actually offered for co-investment, how quickly decisions must be made, and whether the best deals are systematically withheld from the co-investment programme. We recommend investors track co-investment frequency and quality over time to assess whether this right is substantive or cosmetic.*

## **7.5 Environmental, Social & Governance (ESG) Integration**

ESG considerations have become an integral part of AIF investment management, driven by investor demand, global LP diligence standards, regulatory evolution and the growing body of evidence linking strong ESG practices with long-term value creation. For Indian AIFs, ESG disclosures are often driven by the PPM, investor side letters, internal policies, sector-specific obligations and institutional investor expectations. Managers should avoid generic ESG claims and should disclose ESG policy, integration approach and portfolio-level metrics only where they are supported by actual processes and data.

In practice, ESG integration in Indian AIFs varies significantly across managers. Leading managers have built dedicated ESG teams, developed proprietary ESG assessment frameworks aligned with global standards (GRI, SASB, TCFD), and incorporate ESG due diligence as a standard component of investment evaluation. Others treat ESG compliance as a box-checking exercise. For investors, assessing the substantiveness of an IM's ESG programme is now an important dimension of manager due diligence.

<b>Portfolio Management Parameter</b>	<b>Category I</b>	<b>Category II</b>	<b>Category III</b>
Single Investee Concentration Limit	Generally 25% of investable funds, subject to category-specific rules and exemptions	Generally 25% of investable funds, subject to exemptions such as LVF/AI-only framework where applicable	Generally 10% of investable funds, subject to applicable exemptions and PPM
Investment in Other AIFs	Permitted only as specified by AIF Regulations and PPM	Permitted as specified by AIF Regulations and PPM	Permitted as specified by AIF Regulations and PPM
Fund-level Leverage	Not permitted, except temporary borrowing for permitted operational needs	Not permitted, except temporary borrowing for permitted operational needs	Permitted subject to SEBI leverage/exposure limits, risk management and disclosure
Short Selling	Not permitted at fund level as a strategy	Not permitted at fund level as a strategy	Permitted where strategy, category and regulations allow
Derivatives	Only for permitted purposes, if any, under regulations and PPM	Generally limited to permitted hedging or as otherwise allowed	Permitted as part of complex trading strategy subject to regulations
Listed Securities	Subject to category mandate and limits	Subject to strategy and regulations	Core investable universe for many Category III strategies

Table 7.1: Portfolio Management Parameters by AIF Category

## 7.6 Portfolio Monitoring and Value Creation

Post-investment portfolio monitoring is a core IM responsibility. Leading IMs maintain regular engagement with portfolio companies, typically through board representation, board observer rights, or formal portfolio review meetings. These interactions serve multiple purposes: monitoring financial and operational performance against plan, providing strategic guidance and network support, identifying risks early, and preparing for eventual exit.

Value creation in private equity and venture capital AIFs is fundamentally about improving a portfolio company's revenue, margins, management quality, governance, and market position over the investment period. IMs with dedicated operating partner teams, sector-specific expertise, and strong management networks are significantly better positioned to drive value creation than those who manage investments at arm's length.

### *KEY INSIGHT*

*We regularly assist AIF managers and their portfolio companies with valuations at various stages of the investment life cycle, including initial investment valuation, periodic fair value assessment for NAV reporting, and exit valuation benchmarking. One consistent observation: portfolio companies that invest in professional financial reporting, governance improvements, and ESG documentation during the holding period command meaningfully higher exit multiples than those that treat these as optional. The market for well-governed, financially transparent companies is significantly more liquid and competitive.*

## SECTION 4: TAX, COMPLIANCE & REPORTING

# Chapter 8: Taxation of AIFs, Category-Wise Analysis

## 8.1 Overview: The Pass-Through vs. Entity Taxation Divide

The taxation of AIFs is one of the most complex and consequential aspects of the AIF framework, with significant implications for both fund managers and investors. The Income Tax Act, 1961, through Section 115UB, creates a bifurcated tax treatment: Category I and Category II AIFs enjoy pass-through tax treatment (income is taxed in investors' hands, not at the fund level), while Category III AIFs are subject to taxation at the fund level.

This distinction has profound implications for investor net returns and for the structuring of investor bases. Understanding the tax treatment of each category, and the specific provisions applicable to different types of income within each category, is essential for any sophisticated participant in the AIF ecosystem.

## 8.2 Pass-Through Taxation: Category I and Category II AIFs (Section 115UB)

Section 115UB of the Income Tax Act, 1961, and the corresponding provisions under the new Income Tax Act, 2025 once in force as notified, provide pass-through treatment for specified income, other than business income, of Category I and Category II AIFs. Such income is generally deemed to accrue to investors in proportion to their beneficial interest and is taxed in their hands as if they had earned that income directly. The character of income, for example capital gains, interest or dividend, is generally preserved when it passes through to investors. The new Act cross-references should be verified against the notified implementation date and official section mapping before use in transaction documents.

For example, if a Category II AIF realises a long-term capital gain on the sale of listed securities held for more than twelve months, this gain is passed through to investors as long-term capital gains, taxable at the applicable LTCG rate (currently 12.5% under Section 112A, plus applicable surcharge and cess) in the hands of investors, not at the fund level. Similarly, short-term capital gains on listed securities held for less than twelve months attract tax at the rate applicable to the investor.

Business income earned by Category I or Category II AIFs is, however, taxable at the fund level (not passed through). This carve-out is significant, if an AIF's activities cross the threshold from investment to business (a determination that depends on the frequency, volume, and nature of transactions), the entire income of the fund may be treated as business income and taxed at the fund level, effectively eliminating the pass-through advantage.

### KEY INSIGHT

*The distinction between capital gains and business income is one of the most litigated questions in Indian AIF taxation. The Income Tax Department has, in some cases, argued that frequent trading activity by an AIF, particularly in listed securities, constitutes business income rather than capital gains. While the AIF Regulations specifically contemplate trading strategies for Category III (which is taxed at fund level anyway), the boundary for Category I and II is less clear. We strongly recommend that Category II AIFs investing in listed securities establish a documented investment policy that clearly characterises their activities as investment (not trading) and maintain holding periods consistent with this characterisation.*

## 8.3 TDS Provisions for AIF Income

The Finance Act 2015 introduced Section 194LBB of the Income Tax Act, which prescribes Tax Deduction at Source (TDS) on specified income distributed by Category I and Category II AIFs to investors. For resident investors, the commonly applied rate is 10% on income other than business income, subject to the nature of income, exemptions and applicable law. For non-resident investors, TDS applies at rates in force, subject to treaty benefits where conditions such as a valid tax residency certificate and beneficial ownership are satisfied. Cross-references under the Income Tax Act, 2025 should be verified against the official section mapping before publication.

The TDS obligation is triggered at the time of distribution, not at the time income accrues to the fund. This creates a cash flow consideration for investors who may have already reflected the accrued income in their tax returns but receive distributions (net of TDS) in a subsequent period. Investors can claim credit for TDS against their annual tax liability.

## 8.4 Fund-Level Taxation: Category III AIFs

Category III AIFs are generally taxed at the fund level, i.e., income earned at the fund level is subject to tax before distribution to investors. The applicable tax rate depends on the legal structure of the AIF and on the character of the income. For trusts, income may in some cases be taxed at the maximum marginal rate, but capital gains on listed securities may attract specific concessional rates where the income qualifies as capital gains and applicable surcharge caps or special provisions apply. The effective rate should therefore be computed income-stream-wise, not by applying a single headline rate to the entire fund.

However, Category III AIFs that are established as trusts and invest predominantly in listed securities may benefit from the concessional tax rates applicable to capital gains on listed securities, provided the income qualifies as capital gains (and not business income). The application of concessional capital gains rates within the MMR trust framework requires careful analysis and, in practice, is a significant structuring consideration.

Tax Parameter	Category I & II	Category III
Taxation Approach	Pass-through for income other than business income under Section 115UB	Generally fund-level taxation
Capital Gains, LTCG Listed	Taxed in investors hands at applicable special rate, currently 12.5% where conditions apply	Taxed at fund level at applicable rate where income qualifies as capital gains
Capital Gains, STCG Listed	Taxed in investors hands at applicable special rate, currently 20% where Section 111A-type conditions apply	Taxed at fund level at applicable rate where income qualifies as capital gains
Capital Gains, Unlisted	Taxed in investors hands at applicable capital gains rate depending on asset and holding period	Taxed at fund level at applicable rate
Interest / Dividend	Passed through and taxed in investors hands, subject to TDS and exemptions	Generally taxed at fund level, subject to character and structure
Business Income	Taxed at fund level at maximum marginal rate where applicable	Taxed at fund level
TDS on Distribution	Section 194LBB for specified distributions, resident/non-resident rules differ	Generally no Section 194LBB pass-through mechanism
Investor Reporting	Income statement and Form 64C / 64D framework as applicable	NAV and tax distribution reporting as applicable

Table 8.1: Tax Treatment Comparison, Category I/II vs. Category III AIFs

## 8.5 Alternate Minimum Tax (AMT) and Surcharge

Investors receiving pass-through income from Category I or II AIFs must factor in the Alternate Minimum Tax (AMT) under Section 115JC of the Income Tax Act, which applies to non-corporate taxpayers who have claimed specified deductions and whose adjusted total income exceeds Rs. 20 lakh in a financial year (individuals, HUFs, AOPs and BOIs below that threshold are outside AMT). Where it applies, AMT ensures a minimum tax liability of 18.5% (plus surcharge and cess) on the 'adjusted total income' of the investor, including pass-through AIF income. For investors whose regular tax liability on AIF income would otherwise be lower than the AMT, the provision may result in a higher effective tax rate.

Surcharge on income from AIFs, particularly for Category III fund-level taxation, can be a significant burden. For individuals with total income exceeding Rs. 5 crore, the maximum surcharge rate of 25% applies to the income tax liability. Combined with the 4% health and education cess, the effective tax rate for high-income individuals on certain types of income can exceed 40%. Budget 2023 provided some relief by capping the surcharge on long-term capital gains from equity and equity-oriented funds at 15%, but the surcharge structure otherwise remains complex.

#### **PRO TIP**

*The tax treatment of AIF income is a rapidly evolving area, with each Union Budget potentially introducing changes to tax rates, TDS provisions, surcharge structures, and treaty applicability. We strongly recommend that investors in AIFs maintain an ongoing relationship with a qualified tax advisor who specialises in alternative investments, and that they model their after-tax returns under multiple scenarios, including potential adverse changes to the tax framework, before making long-term commitments to close-ended funds.*

#### **KEY INSIGHT**

*One of the most common misconceptions we encounter is the belief that pass-through status for Category I and II AIFs means 'tax-free at the fund level and tax-free in investors' hands.' This is incorrect. Pass-through means that the income is taxed in investors' hands, not that it is exempt from tax. The advantage of pass-through is that investors pay tax at their own applicable rates (which may be lower than the MMR applicable to fund-level taxation), and the character of income (capital gains vs. interest) is preserved. For investors at lower tax brackets or with treaty benefits, the pass-through can result in meaningfully lower effective tax rates than fund-level taxation would produce.*

## SECTION 4: TAX, COMPLIANCE & REPORTING

# Chapter 9: Compliance, Reporting & Disclosure

## 9.1 The Compliance Architecture of an AIF

Regulatory compliance in an AIF is not a periodic event, it is a continuous, multi-layered obligation that runs from registration through the entire life of the fund to its eventual winding up. The AIF Regulations, SEBI circulars, master circulars, and applicable provisions of the Income Tax Act, FEMA, and the Companies Act collectively create a complex compliance landscape that requires dedicated attention and professional oversight.

The investment manager bears primary responsibility for compliance, but the trustee has an independent oversight obligation. SEBI expects both the IM and the trustee to maintain separate compliance frameworks and to not treat compliance as an IM-only function. In practice, the trustee's compliance role often involves reviewing and approving the IM's compliance representations, approving related party transactions, and escalating regulatory concerns to SEBI when required.

## 9.2 SEBI Periodic Reporting Requirements

SEBI has established a comprehensive reporting framework for registered AIFs through its online intermediary portal. Historically, under Regulation 28 and the AIF Master Circular, AIFs filed a detailed quarterly activity report within 15 days of each quarter-end. Pursuant to SEBI's circular dated 4 March 2026, this framework was revised by introducing an Annual Activity Report (AAR) and a lighter Quarterly Activity Report (QAR), with timelines and formats prescribed by SEBI. The compliance chapter should be read with the SEBI Master Circular for AIFs dated 3 June 2026 and subsequent circulars.

The annual report filed with SEBI is more comprehensive, incorporating audited financial statements, detailed portfolio valuations, performance metrics, investor distributions, and a management discussion and analysis (MD&A) narrative. SEBI has recently enhanced requirements for the MD&A section, requiring IMs to discuss their portfolio's performance drivers, risks, and outlook in substantive terms rather than in generic boilerplate language.

### KEY INSIGHT

*We assist multiple AIF managers with their SEBI reporting obligations, and the most common pain point is the quality and consistency of portfolio company data. Many portfolio companies, particularly early-stage or unlisted entities, have limited financial reporting infrastructure, making it challenging for the IM to compile timely, accurate, and SEBI-compliant portfolio data. We recommend that IMs establish standard financial reporting templates for portfolio companies at the time of investment, as a condition of the investment agreement, to ensure that required data flows to the IM smoothly and on schedule.*

## 9.3 Investor Reporting Standards

Beyond SEBI reporting, the AIF Regulations require the IM to provide comprehensive periodic reports to investors. SEBI mandates that investors receive, at a minimum: quarterly portfolio updates including NAV statements; annual audited financial statements of the fund; performance attribution reports showing returns by vintage, sector, and geography; and ad hoc communications for material events (capital calls, distributions, key person events, regulatory notices).

Best practice investor reporting in international private markets goes significantly beyond SEBI minimums. Leading IMs provide investors with: one-page portfolio performance dashboards; attribution

analysis breaking down returns between multiple value creation drivers; benchmark comparisons against relevant public market equivalents; ESG metrics and progress reports; and forward-looking commentary on portfolio company outlooks.

## 9.4 FATCA and CRS Compliance

Indian AIFs must comply with the Foreign Account Tax Compliance Act (FATCA) framework and the OECD's Common Reporting Standard (CRS) for cross-border tax information exchange. Under these frameworks, AIFs (as financial institutions) must conduct due diligence on their investors to identify US persons (for FATCA) and foreign tax residents (for CRS), and must report relevant account information to the Indian tax authorities (CBDT), which then exchange the information with relevant foreign tax authorities.

FATCA and CRS compliance involves investor classification (active vs. passive entity, financial institution vs. non-financial institution), self-certification collection and validation, and annual reporting to CBDT through the Form 61B (the prescribed reporting form for FATCA/CRS). Non-compliance with FATCA can result in the withholding of US-source income and potential regulatory sanctions.

### PRO TIP

*FATCA and CRS compliance is an area where small AIFs and first-time fund managers most frequently underestimate the operational burden. The requirement to collect and validate self-certifications from all investors, and to update these certifications upon any change in circumstances, requires systematic, technology-enabled processes. We recommend AIFs adopt a dedicated fund administration system with built-in FATCA/CRS workflow from the outset, rather than attempting to manage these obligations through manual spreadsheets.*

## 9.5 Anti-Money Laundering (AML) and KYC Obligations

AIFs are designated as 'reporting entities' under the Prevention of Money Laundering Act, 2002 (PMLA), and are required to comply with comprehensive AML and KYC (Know Your Customer) obligations. These include: conducting customer identification and due diligence (CDD) at onboarding; performing enhanced due diligence for high-risk investors (PEPs, non-residents, complex structures); monitoring transactions for suspicious patterns; filing suspicious transaction reports (STRs) with the Financial Intelligence Unit (FIU-India); and maintaining AML compliance records for a minimum of five years.

SEBI and FIU-India periodically issue updated AML guidelines, and AIFs must ensure their AML framework is current with the latest regulatory requirements. SEBI inspections invariably include a review of the AIF's AML programme, and deficiencies in this area can result in show-cause notices and penalties.

Compliance Obligation	Regulatory Basis	Timeline
AIF Regulatory Reporting (AAR/QAR)	AIF Regulations, March 2026 SEBI reporting circular and Master Circular	As per SEBI-prescribed format and timeline
Annual Audited Financial Statements	AIF Regulations and fund documents	Within prescribed timeline, generally within 6 months of fiscal year-end
Annual Investor Report	AIF Regulations and PPM	Within 180 days of fiscal year-end
FATCA / CRS Annual Reporting	CBDT / OECD Framework	Generally by May 31 each year, subject to applicable rules
Material Change Filing / Consent	AIF Regulations, SEBI circulars and PPM	Before effecting specified material change
Valuation / NAV Reporting	AIF Regulations, Master Circular and PPM	At least semi-annual or more frequently where applicable

Compliance Obligation	Regulatory Basis	Timeline
Winding Up / Dissolution Period Reporting	AIF Regulations and SEBI circulars	Upon trigger and as prescribed

Table 9.1: AIF Compliance Calendar, Key Obligations and Timelines

#### KEY INSIGHT

One of the structural weaknesses we observe in many smaller AIFs is the absence of a dedicated compliance officer. Investment managers often assign compliance responsibilities to a junior team member alongside other duties, resulting in compliance being treated reactively (responding to SEBI queries) rather than proactively (building a culture of regulatory excellence). As SEBI's inspection frequency and sophistication has increased, we are now consistently advising all AIFs, regardless of size, to appoint a dedicated principal compliance officer who reports directly to the trustee as well as to the IM.

## SECTION 5: VALUATION, TERMINOLOGY & PRACTICAL ASSESSMENT

# Chapter 10: Valuation of AIF Portfolios

## 10.1 Why Valuation Matters in the AIF Context

Portfolio valuation is, arguably, the most technically demanding and consequential operational function in an AIF's lifecycle. Unlike public market funds where portfolio values are determined by real-time market prices, AIF portfolios consist predominantly of illiquid, unlisted investments whose 'fair value' cannot be observed but must be estimated using professional judgment, appropriate methodologies, and defensible assumptions.

The accuracy and integrity of portfolio valuations affects multiple critical outcomes: NAV computation (the basis for investor reporting, new investor subscriptions, and redemptions in open-ended funds), performance fee computation (carried interest is typically calculated based on realised and unrealised portfolio returns), regulatory compliance (SEBI requires valuations in compliance with prescribed standards), investor decision-making (investors use NAV reports to assess performance and make allocation decisions), and financial reporting (Ind AS 113 requires fair value measurements to meet specific standards for consolidated reporting purposes).

### KEY INSIGHT

*In our valuation practice, we often encounter a fundamental tension inherent in AIF portfolio valuation: the investment manager has an economic interest in higher valuations (through carried interest arrangements tied to unrealised gains), while investors have an interest in conservative valuations that honestly reflect portfolio risk. This tension is the primary reason SEBI has progressively strengthened the independence requirements for AIF portfolio valuers. We fully support these requirements, independent, professionally rigorous valuation is the cornerstone of investor trust in the AIF industry.*

## 10.2 SEBI's Valuation Framework

SEBI's valuation requirements for AIF portfolios are primarily governed by Regulation 23 of the AIF Regulations, read with Chapter 22 of the SEBI Master Circular for AIFs dated 7 May 2024 (which subsumed the standardised valuation circular SEBI/HO/AFD/PoD/CIR/2023/97 dated 21 June 2023, as subsequently modified on 19 September 2024). The key principles of the SEBI valuation framework are: fair value (securities covered by the SEBI Mutual Fund Regulations are valued under those norms, while other securities, typically unlisted, are valued as per the IPEV Guidelines); independence (valuations must be conducted by an independent valuer who is a Registered Valuer Entity registered with IBBI, with the deputed person holding ICAI, ICSI, ICMAI membership or a CFA charter, not by the investment manager itself); consistency (valuation policies must be documented and applied consistently across reporting periods); and disclosure (valuation methodology must be disclosed to investors in the PPM and in periodic reports).

For listed securities, fair value is determined by reference to the market price, typically the closing price on the relevant stock exchange on the valuation date. For unlisted securities, the fair value determination requires the application of valuation methodologies. SEBI's framework identifies the following as acceptable methodologies: Discounted Cash Flow (DCF), Market Comparable Method (using EV/EBITDA, P/E, EV/Revenue multiples from comparable public companies), Net Asset Value (NAV) method for asset-heavy businesses, and the Transaction Multiple Method (using recent arm's length transactions in comparable companies as price benchmarks).

## 10.3 Methodologies for Unlisted Portfolio Companies

### 10.3.1 Discounted Cash Flow (DCF) Method

The DCF method estimates the intrinsic value of a business by discounting its projected free cash flows to equity holders (FCFE) or to the firm (FCFF) at an appropriate discount rate. For equity-level DCF, the discount rate is the cost of equity estimated using the Capital Asset Pricing Model (CAPM) or build-up approaches. For firm-level DCF, the discount rate is the Weighted Average Cost of Capital (WACC).

The DCF method is most appropriate for businesses with relatively predictable cash flows and a sufficient history to support a credible projection. For early-stage companies with negative current cash flows, the DCF requires projecting the path to profitability, which involves significant uncertainty and judgment. In such cases, the DCF must be supplemented with sensitivity and scenario analysis to communicate the range of plausible outcomes.

### 10.3.2 Market Comparable Method

The market comparable method estimates value by applying market-derived multiples (EV/EBITDA, EV/Revenue, P/E, P/BV) from a set of comparable public companies to the portfolio company's relevant financial metrics. The key challenge in applying this method to early-stage or high-growth private companies is identifying truly comparable public companies and determining whether any adjustments are warranted for differences in size, profitability, growth rate, market position, and liquidity.

For AIF portfolio companies in sectors with liquid public market comparables (technology, consumer, healthcare, financial services), the market comparable method is often the most current and market-responsive valuation approach. The valuer must document the comparable set selection rationale, the metrics used, and any adjustments applied, to ensure the valuation is transparent and defensible.

### 10.3.3 Transaction Multiple Method

The transaction multiple method uses EV multiples implied by recent arm's length transactions in the portfolio company's sector as the basis for valuation. This approach is particularly useful when public market comparables are scarce or when recent transactions reflect market-clearing prices more accurately than public market multiples. The transaction database must be carefully curated to exclude distressed sales, related-party transactions, and transactions that are not truly arm's length.

#### *PRO TIP*

*A critical discipline in AIF portfolio valuation is the use of the 'calibration' approach endorsed by the IPEV (International Private Equity and Venture Capital Valuation) Guidelines. Under this approach, the valuer begins by calibrating the valuation model to the original investment price, i.e., confirming that the model, as of the investment date, reproduces the actual transaction price. Subsequent valuations track changes in the company's performance and market conditions relative to this calibrated baseline. Calibration provides a rigorous audit trail that links every valuation change to specific, observable drivers, and makes the valuation far more defensible in regulatory or investor scrutiny situations.*

Valuation Method	Best For	Key Limitation
Discounted Cash Flow (DCF)	Mature, cash-generative businesses	Sensitive to terminal value assumptions
Market Comparable (EV multiples)	Companies with listed sector peers	Comparability adjustments judgmental
Transaction Multiple Method	Recent sector M&A activity available	Transaction data may be stale
Net Asset Value (NAV)	Asset-heavy; holding companies	May understate intangibles / growth
Price of Recent Investment (PORI)	Early-stage, no comparables	Appropriate only for short periods
Adjusted Net Assets	Financial institutions; real estate	Limited applicability to operating cos

Table 10.1: AIF Portfolio Valuation Methodologies, Summary

## 10.4 Role of the Independent Valuer

SEBI mandates that unlisted investments of AIFs be valued by SEBI-registered independent valuers, specifically, valuers registered under the Insolvency and Bankruptcy Board of India (IBBI) as Registered Valuers (Securities or Financial Assets class). The valuer must be independent of the investment manager, the sponsor, the trustee, and the portfolio companies, ensuring that the valuation process is free from conflicts of interest.

The valuer's engagement typically covers: selecting the appropriate valuation methodology for each portfolio company; conducting primary research on the company (management discussions, financial analysis, industry research); identifying and applying appropriate market comparables or DCF assumptions; documenting the valuation basis, assumptions, and conclusions in a formal valuation report; and certifying the fair value to the AIF for NAV computation and regulatory reporting purposes.

### KEY INSIGHT

*The role of the independent valuer in the AIF ecosystem goes beyond technical valuation. We regularly act as an independent valuer for AIF portfolios across sectors, from early-stage technology companies to mature industrial businesses, and our most important contribution is often framing the valuation in a way that helps investors understand the key value drivers, risks, and sensitivities of their portfolio. A well-crafted valuation report should be a genuine investor communication tool, not a perfunctory regulatory compliance document. We invest significant effort in making our AIF valuation reports highly readable and actionable for fund managers and their investors.*

## SECTION 5: VALUATION, TERMINOLOGY & PRACTICAL ASSESSMENT

# Chapter 11: Key Terminologies & Concepts Decoded

The AIF industry has developed a rich, specialised vocabulary drawn from global private markets practice. Mastery of this terminology is essential for investors, advisers, and regulators seeking to engage meaningfully with the AIF ecosystem. This chapter provides detailed explanations of the most important terms and concepts, organised thematically.

## 11.1 Fund Structure Terminology

### Corpus / Target Corpus

The total amount of capital the fund seeks to raise from investors. The 'target corpus' is the intended fundraising amount stated in the PPM, while 'committed corpus' refers to the total investor commitments actually received. A fund may have a 'hard cap' (absolute maximum) and a 'target', the hard cap is the maximum corpus permissible under the PPM, often achieved through the green shoe option.

### Vintage Year

The year in which a fund makes its first investment (or, in some usages, the year in which the fund was closed for investments). Vintage year is a critical benchmarking parameter because funds of the same vintage year compete in the same market environment for similar assets, making performance comparison more meaningful. Comparing a 2019 vintage fund against a 2024 vintage fund would be misleading given the vastly different market environments.

### Investment Period / Commitment Period

The period during which the fund is permitted to make new investments. For close-ended funds, this is typically three to four years from the final close. After the investment period ends, the fund enters the harvesting or realisation phase, during which existing investments are managed and exited but no new investments are made (except follow-on investments into existing portfolio companies, which may be permitted within defined limits after the investment period).

### Fund Life / Fund Tenure

The total duration of the fund from final close to anticipated full wind-up. Typically seven to ten years for private equity funds, often with one or two one-year extension options (at the IM's discretion or with investor consent). Venture capital funds may have longer lives, up to twelve years, to accommodate the longer development timelines of early-stage companies.

## 11.2 Capital Mechanics Terminology

### Commitment

The binding contractual obligation of an investor to invest a specified amount in the fund over its life. A commitment is distinct from a contribution (actual cash paid), at any point during the fund's life, an investor's commitment will exceed their cumulative contributions, with the difference being 'uncalled capital' available for future drawdowns.

### Drawdown / Capital Call

A formal notice from the IM to investors requiring them to contribute a specified portion of their committed (but uncalled) capital to the fund. Capital calls are issued when the fund needs capital to make investments, pay expenses, or maintain reserves. SEBI regulations require that capital calls be accompanied by supporting documentation, the proposed investment approval, the call amount per investor, and the payment deadline.

### Unfunded Commitment / Uncalled Capital

The portion of an investor's total commitment that has not yet been drawn down by the fund. The unfunded commitment represents a contingent liability for the investor, capital that must be contributed when called but is not currently deployed. For cash flow planning purposes, investors must maintain liquidity to meet unfunded commitments.

### Recycling

Recycling refers to the reinvestment of capital returned from portfolio disposals back into new investments, rather than distributing it to investors. Not all AIFs permit recycling, the PPM must explicitly authorise it. Recycling extends the fund's effective investment capacity without requiring additional investor capital and is particularly common in longer-dated funds where early realisations can be redeployed.

Term	Definition	Practical Relevance
Carried Interest (Carry)	IM's share of profits above a hurdle rate	Primary IM performance incentive
Hurdle Rate / Preferred Return	Minimum return investors receive before IM participates in profits	Investor protection mechanism
Catch-Up	IM's mechanism to claim carry once hurdle is exceeded	Determines carry payment timing
Clawback	Obligation of IM to return excess carry if final returns fall short	Protects investors from overpayment
Waterfall	Contractual order in which distributions are allocated	Determines who gets paid first
GP Commitment	Sponsor/IM's own capital invested in the fund	Skin-in-the-game alignment
LP	Limited Partner, investor in the fund	Bears economic risk; limited liability
GP	General Partner / Investment Manager	Bears management responsibility

Table 11.1: Core AIF Economics and Carry Terminology

## 11.3 Performance Measurement Terminology

### IRR, Internal Rate of Return

The IRR is the annualised return rate at which the net present value (NPV) of all cash flows (drawdowns and distributions) equals zero. It is the most widely used performance metric in private markets, capturing the time-value-of-money effect of capital deployment and return timing. A high IRR reflects rapid capital return or strong portfolio performance; a low IRR may reflect delayed capital return even if the absolute multiple of invested capital is attractive.

### DPI, Distributed to Paid-In Capital

DPI measures the ratio of cumulative distributions made to investors relative to the total capital contributed by investors. A DPI of 1.0x means investors have received back exactly their invested capital (breakeven on cash flows). A DPI above 1.0x indicates realised profits; below 1.0x indicates that investors have not yet recovered their full investment in cash. DPI is a 'realised' metric that tracks actual cash returned.

### RVPI, Residual Value to Paid-In Capital

RVPI measures the estimated current fair value of unrealised portfolio investments relative to total invested capital. RVPI represents the 'paper' gain, the portion of the fund's total value that has not yet been converted to cash. An RVPI of 1.5x means that remaining portfolio investments are valued at 1.5 times the capital invested.

### TVPI, Total Value to Paid-In Capital

TVPI is the sum of DPI and RVPI, i.e., total value (realised distributions plus current portfolio fair value) divided by total invested capital. TVPI is the most comprehensive performance multiple for evaluating a fund's overall value creation, capturing both realised and unrealised returns. A TVPI of 2.5x means the fund has generated 2.5 times the capital invested across realised and unrealised components.

### **PME, Public Market Equivalent**

The Public Market Equivalent (PME) is a benchmark that compares an AIF's cash flows against the returns that would have been generated by investing the same cash flows (on the same dates) in a public market index. PME analysis helps answer the question: 'Did the AIF outperform what an investor could have achieved in public markets?', adjusting for the timing of capital calls and distributions.

#### **KEY INSIGHT**

*Performance metrics like IRR, DPI, and TVPI are frequently used by IMs in fundraising materials, sometimes in ways that can be misleading. Gross IRR (before IM fees and carry) is almost always higher than net IRR (after fees and carry), and it is the net IRR that represents the investor's actual experience. Similarly, an impressive IRR on a small initial investment can skew a fund's aggregate performance metrics. When evaluating IM track records, we recommend investors always request net performance data (after all fees and carry) on a fund-by-fund basis, with vintage year context and benchmark comparisons.*

## **11.4 Carry and Waterfall Terminology**

### **Waterfall**

The waterfall is the contractual mechanism governing how proceeds from portfolio disposals are allocated between investors and the IM. A typical private equity waterfall operates as follows: (a) return of invested capital to investors; (b) payment of preferred return (hurdle) to investors on their invested capital; (c) catch-up period where the IM receives a portion of returns to 'catch up' to its carry entitlement; and (d) profit split (typically 80:20 between investors and IM) above the hurdle.

### **Clawback**

The clawback is the IM's obligation to return carry previously received if, at the end of the fund's life, the aggregate carry received exceeds the IM's contractual carry entitlement on the fund's overall performance. Clawback provisions protect investors from situations where the IM receives carry on early successful exits but the fund's overall performance (after accounting for later losses) does not justify that carry. Clawback provisions typically run for three to five years after the fund's final distribution.

#### **PRO TIP**

*One of the most important provisions to review in an AIF's PPM is the clawback mechanism and the IM's financial capacity to honour it. A clawback provision is only as valuable as the IM's ability to actually return the carry, which may be compromised if the IM has already distributed carried interest to its own principals and employees. We recommend investors ask IMs specifically how they operationalise clawback obligations, including whether carry is escrowed, whether individual carry recipients are bound by clawback agreements, and whether the IM maintains a clawback reserve.*

**SECTION 5: VALUATION, TERMINOLOGY & PRACTICAL ASSESSMENT**

# Chapter 12: Pros, Cons & Suitability Assessment

## 12.1 The Case FOR AIFs: Why Sophisticated Investors Allocate

The case for AIF allocation rests on a set of structural advantages that distinguish alternative investments from traditional public market instruments. These advantages have been validated by decades of global private markets data, as well as by the growing maturity of India's own AIF ecosystem.

### 12.1.1 Access to Private Market Alpha

The most compelling argument for AIF investment is access to the private market alpha, the excess return that private equity, venture capital, and private credit funds have historically delivered over public market equivalents. In India, this alpha is amplified by the structural opportunity: a rapidly growing economy with a large number of high-quality businesses that remain unlisted and are accessible only through private market vehicles.

Academic and practitioner research consistently shows that top-quartile private equity funds outperform public market equivalents by 300 to 500 basis points net of fees over comparable horizons. While past performance does not guarantee future results, the structural sources of private market alpha, illiquidity premium, active management, information advantages, and operational value creation, remain compelling in the Indian context.

### 12.1.2 Portfolio Diversification

AIFs provide genuine portfolio diversification benefits beyond what public market instruments can offer. Because AIF portfolios are valued at fair value rather than mark-to-market, their reported returns have lower short-term correlation with public market volatility. For investors managing large portfolios, the ability to hold a portion of their assets in an instrument that does not experience daily mark-to-market volatility has meaningful portfolio construction benefits.

Beyond volatility diversification, AIFs offer sectoral diversification into segments that are underrepresented in public markets. India's listed equity universe, while large, is heavily skewed toward financial services, IT, and consumer sectors. AIFs provide access to private healthcare, clean energy, agri-tech, deep tech, and infrastructure, sectors where India's economic transformation is creating substantial value but where public market representation is limited.

### 12.1.3 Access to Institutional-Quality Investment Management

Top-tier AIF managers bring institutional-quality investment management capabilities that are unavailable through public market instruments. This includes: deep industry expertise and networks; hands-on engagement with portfolio companies; access to proprietary deal flow; and the ability to negotiate favourable entry valuations, governance rights, and contractual protections.

For individual investors and family offices who lack the internal resources to build a private markets investment function, co-investing alongside a skilled AIF manager provides access to professional investment management at a level commensurate with institutional investors, without requiring the investor to build a dedicated team.

**KEY INSIGHT**

*We frequently encounter the question: 'Is an AIF better than direct investment in private companies?' Our honest answer is: it depends on the investor's capacity for due diligence, diversification, and professional engagement. A large family office with a dedicated investment team and extensive industry networks may generate superior risk-adjusted returns through direct investments. For most HNIs and institutional investors who lack this infrastructure, a well-managed AIF is a significantly more efficient vehicle, providing diversification, professional management, regulatory protection, and operational support that direct investment cannot replicate at comparable cost.*

## 12.2 The Case AGAINST AIFs: Risks and Limitations

A balanced assessment of AIFs must candidly acknowledge the significant risks and limitations associated with these instruments. The very features that make AIFs attractive, illiquidity, complexity, concentration, also create meaningful risks that investors must carefully evaluate.

### 12.2.1 Illiquidity Risk

The defining characteristic of most AIFs, particularly close-ended private equity, venture capital, and infrastructure funds, is illiquidity. Investors commit capital for seven to ten years (or longer) with no guaranteed exit mechanism during the fund's life. While secondary markets for AIF units are developing in India, they remain nascent and illiquid relative to global secondary markets. An investor facing unexpected liquidity needs during the fund's life may have limited options, and any secondary sale of AIF units is likely to occur at a significant discount to NAV.

### 12.2.2 High Minimum Investment Threshold

The Rs. 1 crore standard minimum commitment requirement, and the Rs. 25 crore minimum commitment for LVF-AI, position AIFs beyond the reach of most individual investors. While this minimum is consistent with the sophisticated investor profile that the regulatory framework intends to serve, it means that meaningful AIF diversification across multiple funds and managers requires substantial total capital allocation. An investor committing Rs. 1 crore to a single AIF is not diversified; meaningful private markets diversification usually requires exposure across vintage years, managers, sectors and strategies.

### 12.2.3 Complexity and Information Asymmetry

AIFs are inherently more complex than public market instruments. The complexity spans multiple dimensions: legal (trust deeds, contribution agreements, waterfall mechanics); financial (NAV computation, fair value estimation, IRR attribution); regulatory (SEBI reporting, FATCA/CRS, AML/KYC); and operational (capital calls, side pockets, co-investments). Investors who do not invest time in understanding these dimensions are at a significant disadvantage relative to sophisticated institutional co-investors.

Information asymmetry between the IM and investors is an inherent feature of private markets. Unlike public companies, portfolio companies have no obligation to disclose information publicly. Investors are dependent on the IM's disclosures, which, despite SEBI's strengthened reporting requirements, remain significantly less transparent than public market disclosures.

### 12.2.4 Manager Risk

Perhaps the most significant risk in AIF investing is manager risk, the risk that the investment manager fails to deliver the performance necessary to justify the fees, the illiquidity, and the complexity. Private markets returns are significantly more dispersed than public market returns, the gap between top-quartile and bottom-quartile private equity managers is far wider than the equivalent dispersion in public equity fund management. Selecting the wrong manager in the AIF context is far more costly than selecting the wrong mutual fund, given the seven-year-plus lock-in period.

**PRO TIP**

*The most important discipline in AIF investing is manager selection. We recommend investors conduct structured due diligence across four dimensions: (a) Investment thesis, is the fund's strategy differentiated, defensible, and appropriate for the current market environment? (b) Team, is the team experienced, stable, and truly aligned with investor interests through meaningful personal capital commitment? (c) Track record, what is the fund's net return track record (after all fees and carry) across full investment cycles? (d) Infrastructure, does the IM have the compliance, operational, and investor communication infrastructure to manage the fund professionally? Weak performance on any of these dimensions is a serious concern that should not be overlooked in the excitement of a well-marketed fund offering.*

## 12.3 Suitability Framework: Who Should Invest in AIFs?

AIFs are not appropriate for all investors. The SEBI regulatory framework rightly limits AIF participation to investors above minimum financial thresholds, recognising that these instruments require a level of financial sophistication, risk tolerance, and liquidity capacity that not all investors possess. Beyond the regulatory minimum, however, each investor must assess their individual suitability for AIF investment.

Investor Profile	AIF Suitability	Key Considerations
Ultra-HNI / Family Office	High	Target 15-25% allocation to alternatives; consider multi-fund diversification
Institutional (Insurance, Pension)	High (Cat I & II)	Regulatory constraints on Cat III; pass-through tax efficient
Domestic Corporate Treasury	Moderate	Liquidity constraints; SEBI approval may be needed for investments
Foreign Institutional Investor	High	Treaty tax analysis critical; currency hedging for INR exposure
High Net Worth Individual	Moderate	Concentrated liquidity risk at Rs.1 Cr minimum; ensure genuine illiquidity capacity
Retail Investor	Not Eligible	Below minimum threshold; public market instruments more appropriate

Table 12.1: AIF Suitability by Investor Category

## 12.4 Due Diligence Checklist Before Investing in an AIF

Before committing to an AIF, investors should conduct rigorous due diligence across all dimensions of the fund's strategy, team, governance, legal structure, and tax implications. The following checklist distils the key questions that informed investors should seek to answer.

**Investment Strategy:** Is the strategy clearly differentiated? Does it align with current market conditions?

**Manager Track Record:** What are the net IRR, DPI, and TVPI across previous funds managed by the same team?

**Team Stability:** Has the investment team been stable across prior funds? What are the key person provisions?

**PPM Review:** Have all material terms, fees, carry, hurdle, waterfall, clawback, been reviewed by independent legal counsel?

**Tax Analysis:** Has the investor received a clear tax opinion on the treatment of AIF income given their specific tax profile?

**Liquidity Planning:** Can the investor comfortably meet capital calls across the fund's investment period without distress?

**Valuation Policy:** Is the valuation methodology clearly described in the PPM? Who is the independent valuer?

**Reference Checks:** Have independent reference checks been conducted on the key investment team members?

**Co-Investor Quality:** Who else is investing? Large institutional co-investors are a meaningful quality signal.

**SEBI Registration:** Has the fund's SEBI registration been independently verified on the SEBI intermediary portal?

#### **KEY INSIGHT**

*We have participated in investor due diligence processes for AIFs across all three categories, acting both as advisers to investors and as independent valuers to funds. The single most important piece of advice we give to prospective AIF investors is this: treat your AIF investment as a business relationship, not a financial product purchase. You are entering a ten-year partnership with the investment manager. The quality, integrity, and alignment of that manager will determine your outcome far more than any contractual provision in the PPM.*

## CONCLUSION

# Conclusion: Working With an AIF & Fund Valuation Expert

### **Navigating the AIF Landscape: When to DIY and When to Seek Expert Help**

India's AIF ecosystem has evolved into one of the most dynamic and complex segments of its financial architecture. Over the course of this guide, we have traversed the historical origins of the regulatory framework, the detailed architecture of each AIF category, the mechanics of fund structuring and fundraising, the technical intricacies of taxation and compliance, and the professional discipline of portfolio valuation.

Our intention has been to equip readers, whether fund managers, institutional investors, family offices, or professional advisers, with a truly practitioner-grade understanding of AIFs. We have consistently aimed to make 70% of the content implementable without professional assistance, while being candid about the 30% of complexity that truly warrants expert engagement.

So where does DIY end and professional expertise begin? The answer is different for different participants in the ecosystem.

### **For Fund Managers and Sponsors**

The structural decisions around AIF formation, category selection, legal form, trustee selection, PPM preparation, appear simple on paper but carry long-term consequences that are difficult or impossible to reverse. A fund's category determines its tax treatment, investment restrictions, and regulatory obligations for its entire life. An imprecisely drafted trust deed can create governance gaps that become contested when interests diverge. A PPM with unclear carry mechanics can generate costly disputes between the IM and investors at exit.

We strongly recommend professional engagement at the formation stage, not because the regulatory framework is impenetrable, but because the cost of getting it wrong is so much greater than the cost of getting it right from the outset. Similarly, the SEBI registration process, while more streamlined than in earlier years, benefits significantly from experienced guidance to anticipate SEBI queries and present the fund's case compellingly.

### **For Investors**

An investor's most important decision in the AIF context is manager selection, and this is an area where independent advice is consistently undervalued. Most investors rely heavily on the fund's own marketing materials and on the IM's verbal representations, without conducting the structured, independent due diligence that the commitment warrants. Given the seven to ten year lock-in period and the meaningful minimum investment size, independent advice at the subscription stage is a highly cost-effective risk management measure.

Tax planning around AIF investments is another area where professional expertise consistently generates positive returns on the advisory spend. The interaction between pass-through income, AMT, surcharge, and treaty provisions creates genuine complexity that requires individual analysis, generic guidance is rarely adequate.

### **How Elite Valuation Can Help**

Elite Valuation is a boutique advisory and valuation firm that has developed deep, specialised expertise in the AIF and alternative investment ecosystem. Our engagement model is built around delivering genuine value at every stage of the AIF lifecycle, from structuring and registration through compliance, valuation, and exit.

AIF Portfolio Valuation: SEBI-compliant independent valuations of unlisted portfolio companies for NAV computation, investor reporting, and regulatory filings, using DCF, market comparable, transaction

multiple, and hybrid methodologies.

**AIF Structure & Registration Advisory:** End-to-end support for AIF structuring, SEBI registration applications, trust deed review, PPM preparation, and investment policy documentation.

**Tax Structuring and Investor Tax Advisory:** Analysis of pass-through tax implications, investor-level tax planning, TDS compliance, treaty analysis for foreign investors, and budget impact assessments.

**Independent Due Diligence Support:** Structured independent due diligence for investors evaluating AIF subscriptions, covering strategy, team, governance, valuation policy, and legal documentation.

**SEBI Compliance and Reporting Support:** Assistance with periodic SEBI filings, FATCA/CRS compliance, AML framework review, and preparation of standardised investor reports.

**Portfolio Company Valuation:** Fair value assessments of AIF portfolio companies for Ind AS 113 reporting, goodwill impairment testing, ESOP valuation, and M&A transactions.

**Expert Witness and Litigation Support:** Independent expert opinions on AIF valuation disputes, carried interest computations, and performance attribution analyses for arbitration or judicial proceedings.

**Investor Education and Workshops:** Customised workshops for family offices, corporate investors, and institutional teams on AIF fundamentals, due diligence frameworks, and performance measurement.

"The best time to understand an AIF's structure, governance, and tax profile is before you invest, not after. Our role is to make sure that the clients who work with us enter these commitments with their eyes wide open, and that the fund managers we advise build vehicles that stand the test of time, regulatory scrutiny, and investor trust."

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