

Portfolio Manager

LEARNING OBJECTIVES: PMS Overview • Discretionary vs Non-Discretionary • Registration • Fees & Costs • Direct Access • P

Sneha Rege

1 Overview — What is Portfolio Management Service (PMS)?

A **Portfolio Manager** is a body corporate that, pursuant to a contract with a client, advises, directs or undertakes the management or administration of a portfolio of securities or the client's funds. Portfolio managers are registered and regulated under **SEBI (Portfolio Managers) Regulations, 2020**. PMS can only be offered by SEBI-registered entities. PMS regulations were among the very first issued by SEBI — even before Mutual Fund regulations (introduced January 1993), highlighting the sector's importance.

<p>■ 50L Minimum Ticket</p> <p>Portfolio manager cannot accept funds/securities worth less than Rs.50 lakh from a client</p>	<p>■ Regulated By</p> <p>SEBI (Portfolio Managers) Regulations, 2020. Major providers: big brokerages, AMCs, boutique houses</p>	<p>■ 5Cr Net Worth Req.</p> <p>Applicant must have minimum net worth of Rs.5 crore to obtain SEBI registration</p>	<p>■ Fiduciary Duty</p> <p>Portfolio manager acts in a fiduciary capacity with regard to client's funds — client interest first</p>
---	--	---	--

2 Types of Portfolio Management Services

By Service Provider:

1. PMS by Asset Management Companies (AMCs)
2. PMS by Brokerage Houses
3. Boutique (Independent) PMS Houses

By Product Class:

Equity-based PMS | Fixed Income PMS | Commodity PMS | Mutual Fund PMS | Multi-Asset PMS

Service Type	Who Decides?	Who Executes?	Key Feature
Discretionary	Portfolio Manager decides independently	Portfolio Manager	Full autonomy; manages each client separately; cannot pool like MF
Non-Discretionary	Client decides what to buy/sell and when	Portfolio Manager	PM consults client every transaction; execution only by PM
Advisory	Client decides and executes	Client	PM gives non-binding investment ideas; typical for institutional clients

KEY DISTINCTION

Discretionary PMS: PM acts independently per pre-agreed strategy. **Non-Discretionary:** PM executes only after client's explicit approval of every trade. **Advisory:** PM suggests, client decides AND executes — PM has no execution role.

3 Registration Requirements for a Portfolio Manager

Obtaining a **Certificate of Registration from SEBI** is mandatory to act as a portfolio manager. Application is made in **Form A of Schedule I** along with a non-refundable fee. Certificate is valid unless suspended or cancelled by SEBI.

Requirement	Detail
Entity Type	Must be a body corporate (legal entity)
Infrastructure	Adequate office space, equipment, manpower to effectively discharge PMS activities
Compliance Officer	Must appoint a dedicated Compliance Officer
Principal Officer	Professional qualification (finance/law/accountancy/business management) + min 5 years relevant securities market experience + NISM certification
Additional Staff	At least 1 additional person with graduation + min 2 years securities market experience
Net Worth	Rs.5 crore minimum
Fit and Proper	No conviction for moral turpitude / economic offences; no adverse pending litigation

4 Responsibilities of a Portfolio Manager

Segregate Client Funds	Each client's portfolio held in separate accounts; client funds in separate Scheduled Commercial Bank account
Minimum Investment	Cannot accept funds or securities worth less than Rs.50 lakh from any single client
Fiduciary Duty	Act in a fiduciary capacity — client interest at all times; no direct/indirect personal benefit from client funds
Associate Limits	Maximum 30% of client portfolio may be invested in associates/related party securities (one-time written consent required)
Credit Quality	Shall NOT make investments in below investment grade securities
No Borrowing	Cannot borrow funds or securities on behalf of the client; cannot lend client securities to third parties (except as permitted)
Complaint Handling	Ensure proper and timely handling of client complaints; take appropriate action immediately
No Pooling	Discretionary PM must manage each client independently — must not partake character of a Mutual Fund

5 Costs, Expenses & Fees of Investing in PMS

Fee Component	Description	Key Point
Fixed Cost	Fixed % of AUM regardless of performance (e.g., 1% p.a.). Also includes brokerage and transaction costs charged at actuals.	Paid irrespective of gains or losses on portfolio
Performance / Profit-Sharing Fee	Additional fee charged if returns cross the hurdle rate. Incentivises the fund manager to deliver superior returns.	Can be significant; investor must track total effective cost
High Watermark	Profit-sharing fee calculated only if portfolio crosses previous highest NAV at which fees were last paid. Protects against double-charging.	PM cannot charge performance fee on recovering prior losses
Hurdle Rate	Minimum return that must be achieved before performance fee calculation starts. Stated in PMS agreement (e.g., 8% p.a.).	Returns below hurdle rate = no performance fee charged
Catch-Up	Once hurdle rate crossed, PM earns fees on ALL gains from zero (including up to hurdle rate). More lucrative for PM.	Higher total payout to PM vs no-catch-up arrangement

Fee Component	Description	Key Point
No Catch-Up	Performance fee calculated ONLY on incremental gains above the hurdle rate — not on the portion below hurdle.	More investor-friendly; lower performance fee outgo

WORKED EXAMPLE

High Watermark: Portfolio = Rs.50L. Grows to Rs.60L → profit share on Rs.10L. Next year drops to Rs.55L. **NO performance fee** until value crosses Rs.60L again. | **Hurdle Rate = 8%:** If return is 6% → zero performance fee. If return is 12% → fee calculated on gains above 8% (no catch-up) or from 0% (catch-up), per agreement terms.

6 Direct Access Facility in PMS

Similar to the **Direct Plan in Mutual Funds**, SEBI mandates that every PMS provider must offer a **Direct Access Facility** where investors approach the PMS directly — without any distributor/intermediary. This results in **lower costs** (no distributor commission) and hence higher net returns for the investor. The investment management process and strategy remain identical to the regular plan.

Dimension	Regular PMS Plan	Direct Access PMS
Intermediary	Via distributor / broker	No intermediary — directly with PMS provider
Cost	Higher — includes distributor commission	Lower — no commission expense
Net Returns	Lower due to higher expense deduction	Higher — cost saving compounds over time
Investment Process	Same underlying portfolio and strategy	Same underlying portfolio and strategy
Role of IA	May recommend regular plan if client needs support	IA should guide clients to Direct Access to save costs

7 SEBI Requirements on Performance Disclosure

Before taking on a portfolio, the PM must **enter into a written agreement** with the client specifying all terms. The PM must also provide a **Disclosure Document** covering: fees quantum and manner of payment, portfolio-specific risks per investment approach, related-party disclosures (per ICAI Accounting Standards). The Disclosure Document must be **filed with SEBI and published on the PM's website**. Performance must be disclosed **uniformly** across: SEBI filings, marketing materials, client reports and website.

CHAPTER 12 — QUICK REVISION: PORTFOLIO MANAGER

Portfolio Manager	Body corporate advising/managing client portfolio of securities under SEBI (PM) Regulations, 2020.
Minimum Investment	PM cannot accept less than Rs.50 lakh from any single client.
Discretionary PMS	PM exercises full discretion independently — manages each client separately; cannot pool funds like MF.
Non-Discretionary	Client takes every buy/sell decision; PM only executes the trade with client's explicit consent.
Advisory PMS	PM gives non-binding advice only; client decides AND executes all transactions independently.
Registration	Certificate from SEBI mandatory. Net worth ≥ Rs.5Cr. Principal Officer: 5 yrs exp + NISM cert.
Fixed Fee	Fixed % of AUM irrespective of performance. Plus actual brokerage and transaction costs.
Performance Fee	Charged only when returns exceed the hurdle rate. High watermark prevents double-charging.
Hurdle Rate	Minimum return threshold specified in PMS agreement before any performance/profit-sharing fee starts.
High Watermark	Performance fee applies only when portfolio crosses its previous highest value. Investor-protective.

Catch-Up	PM earns performance fee from first rupee of gain (inclusive of hurdle portion). Higher PM payout.
No Catch-Up	Performance fee only on incremental returns above hurdle rate. More investor-friendly arrangement.
Direct Access	SEBI-mandated facility — investor goes directly to PMS, no distributor; lower cost, same strategy.
Disclosure Doc	Must detail fees, portfolio risks, related-party disclosures. Filed with SEBI and on PM website.
Associate Limit	Max 30% of client portfolio in PM's associates/related parties. One-time written client consent needed.

■ MCQ PRACTICE — Chapter 12 — Portfolio Manager

10 Questions | Answers shown below each question

1 What is the MINIMUM investment amount a Portfolio Manager can accept from a single client under SEBI regulations?

- a) Rs.10 lakh — minimum for retail HNI investors
- b) Rs.25 lakh — minimum for accredited investors under PMS
- c) Rs.50 lakh — mandatory minimum per SEBI Portfolio Managers Regulations**
- d) Rs.1 crore — same threshold as Alternative Investment Funds

✓ **Answer: c) Rs.50 lakh — mandatory minimum per SEBI regulations**

Under SEBI (Portfolio Managers) Regulations 2020, the portfolio manager SHALL NOT accept from any client funds or securities worth **less than Rs.50 lakh**. This higher ticket size distinguishes PMS from mutual funds (which accept even SIPs of Rs.100) and is designed to limit PMS to sophisticated, high-net-worth investors who can bear the associated risks and costs.

2 In a Non-Discretionary PMS arrangement, who takes the investment decisions?

- a) The Portfolio Manager takes all buy/sell decisions independently
- b) The client takes decisions; the PM only executes trades**
- c) SEBI approves each transaction in a non-discretionary arrangement
- d) The custodian bank takes decisions based on pre-set mandates

✓ **Answer: b) Client takes decisions; PM only executes trades**

In Non-Discretionary PMS: the client retains full decision-making authority — deciding *WHAT* to buy/sell and *WHEN*. The Portfolio Manager's role is limited to execution of the client's explicit instructions. The PM must consult the client before every transaction. This contrasts with Discretionary PMS where the PM independently manages the portfolio without needing client approval for individual trades.

3 What is the "High Watermark Principle" in PMS fee calculation?

- a) The minimum return (hurdle rate) that must be earned before any performance fee is charged
- b) The maximum management fee percentage the PM can charge irrespective of performance
- c) Performance fee is charged only when portfolio value crosses its previous highest level at which fee was last collected**
- d) The maximum portion of portfolio that can be invested in below-investment-grade securities

✓ **Answer: c) Performance fee only when portfolio crosses previous highest value**

The **High Watermark Principle** ensures investors are not charged performance fees for recovering previously lost ground. If the portfolio grew to Rs.60L (fee charged), then fell to Rs.55L, then recovered to Rs.58L — NO performance fee is charged until value surpasses Rs.60L again. This protects investors from paying fees on return of capital that had previously declined. It ensures the PM is rewarded only for true net positive performance above the prior peak.

4 What is the key difference between "Catch-Up" and "No Catch-Up" in PMS fee structures?

- a) Catch-up means PM charges fees even below the hurdle rate; no catch-up means fees are charged only above hurdle
- b) Catch-up: PM earns fees on all gains including hurdle portion; No catch-up: fees only on gains above hurdle rate**
- c) Catch-up is for discretionary PMS; no catch-up is applicable only for advisory services
- d) Catch-up means the investor can recover prior losses before fees are charged; no catch-up has no such provision

✓ **Answer: b) Catch-up: fees on all gains; No catch-up: only incremental above hurdle**

Once returns exceed the hurdle rate: **Catch-Up** — PM earns performance fee on the ENTIRE gain from zero (including the hurdle portion), "catching up" to total returns. **No Catch-Up** — PM earns performance fee ONLY on the incremental gain above the hurdle rate. Example: Hurdle = 8%, Actual = 14%. Catch-up: fee on 14%. No catch-up: fee on 6% (14%-8%). No catch-up is more investor-friendly as it reduces the total performance fee outgo.

5 Which requirement must a Principal Officer of a PMS firm meet for SEBI registration?

- a) Only a graduate degree in any discipline with minimum 3 years of work experience anywhere
- b) Professional qualification in finance/law/accountancy/business management + 5 yrs securities market experience + NISM certification**
- c) CA or CFA designation with 10 years minimum experience in portfolio management specifically
- d) SEBI registration as individual investment adviser with 7 years independent practice

✓ **Answer: b) Professional qualification + 5 years securities market experience + NISM certification**

SEBI specifies that the **Principal Officer** must have: (1) Professional qualification in finance, law, accountancy OR business management; (2) Minimum **5 years** of related experience in securities market — this could be at a portfolio manager, stock broker, investment adviser, research analyst or as a fund manager; AND (3) Valid **NISM certification** as specified by the regulator from time to time. All three conditions are mandatory cumulatively — meeting just one or two is insufficient.

6 What is the maximum percentage of a client's PMS portfolio that can be invested in securities of the PM's associates/related parties?

- a) 10% — to prevent excessive related-party concentration
- b) 20% — standard regulatory limit for all managed accounts
- c) 30% — with mandatory one-time written consent from the client**
- d) 50% — if the client provides ongoing quarterly approval

✓ **Answer: c) 30% — with one-time written consent from the client**

SEBI regulations allow Portfolio Managers to invest a **maximum of 30%** of a client's portfolio in securities of their own associates or related parties. However, this requires a **one-time written consent** from the client upfront. This rule prevents conflicts of interest while still allowing the PM some flexibility to invest in group companies they may know well. The client consent requirement ensures transparency and informed decision-making.

7 Why must a Discretionary Portfolio Manager NOT pool client funds like a Mutual Fund?

- a) Pooling is allowed only for equity portfolios — not fixed income PMS mandates
- b) Each client must be managed individually and independently with a separate account; pooling violates PMS regulations**
- c) Pooling requires a separate RBI licence which portfolio managers do not possess under their SEBI registration
- d) Pooled accounts are permitted for clients with the same risk profile under the same investment approach

✓ **Answer: b) Each client managed individually; separate account mandatory — pooling violates regulations**

SEBI regulations explicitly state that the discretionary PM **shall individually and independently manage each client's funds** — it must NOT partake the character of a Mutual Fund. Unlike MFs where thousands of investors pool money into a common portfolio, PMS must maintain **separate accounts for each client**. Each client's portfolio reflects their individual mandate, risk profile, and instructions. Custodian must hold segregated assets. This is a fundamental structural distinction between PMS and Mutual Funds.

8 What is the purpose of the Disclosure Document that a Portfolio Manager must provide to every client?

- a) It is the client's portfolio statement showing current holdings and unrealised profits/losses
- b) It details fees, portfolio risks per investment approach, related-party disclosures — must be filed with SEBI and on PM's website**
- c) It is the client's KYC document certifying the investor's financial eligibility for PMS investment
- d) It is the quarterly performance report comparing PM's returns against benchmark indices

✓ **Answer: b) Fees, portfolio risks, related-party disclosures — filed with SEBI and published on website**

The **Disclosure Document** must be provided BEFORE the PM takes on portfolio management. It must contain: (1) Quantum and manner of fees for each service; (2) Portfolio risks specific to each investment approach offered; (3) Related-party disclosures per ICAI Accounting Standards; (4) Other prescribed particulars. Crucially, it must be both **filed with SEBI** and made available on the **PM's website**. Performance reporting must be **uniform** across SEBI filings, marketing materials, client reports, and website.

9 In an Advisory PMS arrangement, who is responsible for executing the transactions?

- a) The Portfolio Manager, as they are the registered entity with SEBI and hold the securities
- b) The Custodian bank executes trades on behalf of the advisory client automatically
- c) The client themselves — they decide and execute; PM only provides non-binding advice**
- d) A registered broker designated by the PM handles all execution for advisory clients

✓ **Answer: c) Client decides and executes — PM provides non-binding advice only**

In the **Advisory PMS model**, the Portfolio Manager only provides investment ideas or non-binding advice. The investor makes the final investment decision AND is responsible for executing the transactions themselves. The PM has no execution role whatsoever. This model is typically used by large institutional clients who manage their own portfolios but hire specialists (like country experts) for domain-specific investment advice. The PM bears no fiduciary responsibility for actual portfolio outcomes in pure advisory mode.

10 The minimum net worth required for SEBI registration as a Portfolio Manager is:

- a) Rs.1 crore — same as SEBI-registered investment adviser
- b) Rs.2 crore — minimum for brokerage and portfolio firms
- c) Rs.5 crore — as per SEBI (Portfolio Managers) Regulations 2020**
- d) Rs.10 crore — required for category III AIF and PMS alike

✓ **Answer: c) Rs.5 crore — as per SEBI (Portfolio Managers) Regulations 2020**

SEBI requires that an applicant for a Portfolio Manager certificate fulfil a **minimum net worth of Rs.5 crore**. This significant capital requirement ensures that only financially sound entities operate as portfolio managers, providing some cushion for operational risks and client protection. The net worth must be maintained on an ongoing basis, not just at the time of initial registration. This is higher than the requirement for investment advisers but lower than the Rs.10 crore+ requirements for some other categories.

Alternative Investment Funds (AIFs)

LEARNING OBJECTIVES: AIF Introduction • Evolution in India • SEBI Requirements • Category I / II / III • Types of AIFs •

Sneha Rege

1 Introduction — What are Alternative Investments?

Alternative Investments are broadly defined as investments *other than* traditional investments. Traditional investments include listed stocks, bonds, general mutual funds and ETFs — liquid instruments available to general investors. Alternative investments cater to **sophisticated investors** (institutional investors, HNIs) with higher risk-taking capability who need more complex avenues to complement their traditional holdings and improve **risk-adjusted returns** over the long term.

Dimension	Traditional Investments	Alternative Investments
Target Investors	General public — all risk profiles	HNIs, institutional investors, sophisticated parties
Liquidity	HIGH — listed on market; open-ended MFs redeemable anytime	LOW — illiquid; off-market or complex structures; no ready exit
Returns Profile	Market-linked; generally lower risk	Potentially higher returns with commensurately higher risk
Examples	Stocks, bonds, MF units, ETFs	Venture Capital, Private Equity, Hedge Funds, Debt Funds, AIFs
Regulation	SEBI (MF Regs, LODR, etc.)	SEBI (Alternative Investment Funds) Regulations, 2012
Purpose	Primary wealth-building for broad investor base	Complement traditional portfolio; diversify into non-correlated assets

KEY CHARACTERISTIC

Traditional investments: Primary feature is **liquidity** (near-cash; market exit or open-ended redemption).
Alternative investments: Defining feature is **illiquidity** — either off-market, long lock-ins, or complex structures with no secondary market. Investors are compensated for this illiquidity through higher potential returns (illiquidity premium).

2 SEBI AIF Regulations — Key Requirements

Governed by **SEBI (Alternative Investment Funds) Regulations, 2012**. An AIF is a **privately pooled investment vehicle** — funds pooled from select investors (not general public) for a defined investment policy. Maximum **1,000 investors** per scheme (via private placement only).

Parameter	Requirement
Definition	Privately pooled investment vehicle. Funds pooled from India or abroad for a defined investment policy.
Minimum Corpus per Scheme	Rs.20 crore — each AIF scheme must have at least this corpus
Minimum Investment per Investor	Rs.1 crore (General); Rs.25 lakh for employees/directors of the AIF/Manager

Parameter	Requirement
Accredited Investor	Ticket size of Rs.25 lakh (instead of Rs.1 crore). Eligible: Individual with income \geq Rs.2Cr OR net worth \geq Rs.7.5Cr (with \geq Rs.3.75Cr in financial assets); Body corporate net worth \geq Rs.50Cr
Maximum Investors	1,000 investors per scheme — private placement only; not from general public
Manager/Sponsor Skin-in-Game	Continuing interest: min 2.5% of corpus OR Rs.5Cr (lower). For Cat III: min 5% OR Rs.10Cr (lower)
Listing	Close-ended AIF units may list on exchange; min tradable lot = Rs.1 crore; listing only after final close of fund/scheme
Investment in Single Company	Cat I & II: max 25% of investable funds. Cat III: max 10% of investable funds
Uninvested Funds	May be parked in liquid MFs, bank deposits, T-Bills, CBLOs, CPs, CDs till deployment

3 Three Categories of AIFs — Comparison

Category	Focus	Leverage Permitted?	Examples	Govt. Incentives?
Category I	Start-ups, early-stage, SMEs, social ventures, infrastructure — socially/economically desirable sectors	No (except day-to-day operational needs)	Venture Capital Funds, Angel Funds, SME Funds, Social Venture Funds, Infrastructure Funds, Special Situation Funds	Yes — special incentives from Govt/regulators
Category II	Private Equity, Debt Funds — no specific incentives; operates normally without complex trading strategies	No (only day-to-day operational borrowing)	Private Equity Funds, Debt Funds, Funds of Funds not in Cat I or III	No — no special incentives or concessions
Category III	Complex/diverse trading strategies; may invest in listed/unlisted derivatives; often open-ended	Yes — may use leverage including through derivatives	Hedge Funds, Long-short funds, funds making short-term returns	No — no special incentives or concessions

QUICK RULE

Cat I: Govt wants to encourage — invests in productive sectors (startups, infra, SMEs, social). **Cat II:** Standard PE/debt — no special treatment; no leverage. **Cat III:** Complex, leveraged, sophisticated strategies (hedge funds, derivatives) — highest regulation on manager's skin-in-game (5% or Rs.10Cr).





4 Types of AIFs — Detailed Overview

AIF Type	Category	Definition & Key Features
Venture Capital Fund (VCF)	Category I	Invests primarily in unlisted securities of start-ups and early-stage ventures involved in new products, services, technology, IP, or new business models. First stage of institutional financing after angel stage. Best for asset-light, tech-intensive businesses.
Angel Fund	Category I (sub-category of VCF)	Raises funds from Angel Investors for early-stage investments. Angel Investor: Individual with net tangible assets \geq Rs.2Cr (excl. principal residence) + early-stage investment experience OR serial entrepreneur OR senior management with 10+ years experience. Body corporate net worth \geq Rs.10Cr.
Private Equity Fund (PE)	Category II	Invests primarily in equity or equity-linked instruments of investee companies. Unlike VCF (early-stage), PE focuses on later-stage financing — established business models needing scaling. Equity-linked includes convertible instruments, warrants, preference shares, compulsorily convertible debentures.
Debt Fund	Category II	Invests primarily in debt or debt securities of listed or unlisted companies. Includes mezzanine financing (debt + equity warrants), leveraged loans (subordinate debt), venture debt, and distressed debt financing (IBC proceedings, insolvency resolution). Illiquid private debt is the defining feature.

AIF Type	Category	Definition & Key Features
Infrastructure Fund	Category I	Invests in unlisted securities, listed debt, or securitised debt of companies/SPVs in infrastructure projects . High illiquidity, long gestation periods, long amortisation cycles. Primarily sovereign wealth funds and multi-lateral agencies participate.
SME Fund	Category I	Invests in unlisted securities of SMEs or SMEs listed/proposed to be listed on SME exchanges. SME as defined under MSME Act 2006. Supports small business financing not serviced by mainstream PE or VC.
Hedge Fund	Category III	Employs diverse or complex trading strategies ; invests in securities with diverse risks or complex products including listed and unlisted derivatives . Can be long/short, leveraged. Designed for sophisticated investors only.
Social Impact Fund	Category I	Invests in securities of social ventures — entities formed for social welfare, solving social problems or delivering social benefits. Includes public charitable trusts, Section 8 companies, microfinance institutions, registered societies for charitable purposes.
Special Situations Fund	Category I	Invests in special situation assets per investment objectives. May act as a resolution applicant under IBC 2016 . Focuses on distressed assets, turnaround opportunities, and restructuring situations.

5 Role of Alternative Investments in Portfolio Management

Portfolio management must evolve constantly to meet investor return expectations. New challenges in the 21st century — technological disruption, environmental concerns, regulatory change, geo-political volatility, and low/zero interest rates in developed economies — have pushed sophisticated investors toward alternative investments. The rationale goes beyond just returns:

 Return Enhancement Access to asset classes with potentially higher returns than public markets — e.g., early-stage VC, PE buyouts	 Diversification Low correlation with traditional asset classes (stocks/bonds) reduces overall portfolio volatility	 Illiquidity Premium Investors earn extra return for accepting illiquidity — compensation for locked-in capital over long horizons	 Inflation Hedge Real assets (infra, real estate) and commodities in AIFs can serve as natural inflation hedges for HNI portfolios
--	---	--	--

Key investor categories in AIFs globally: Pension funds, investment banks, insurance companies, endowment funds, family offices, sovereign wealth funds, HNIs, and fund of funds. All have large pools seeking returns beyond what public markets and traditional investments can offer.

CHAPTER 13 — QUICK REVISION: ALTERNATIVE INVESTMENT FUNDS

Alternative Investment	Investments other than traditional ones (stocks, bonds, MFs). Defined by illiquidity and higher risk/return.
SEBI AIF Regulations	SEBI (Alternative Investment Funds) Regulations, 2012 govern all AIFs in India.
Privately Pooled	Funds from select investors only — NOT from general public. Private placement; max 1,000 investors per scheme.
Min Corpus	Rs.20 crore minimum corpus per AIF scheme.
Min Investment	Rs.1 crore per investor (Rs.25L for employees/directors; Rs.25L for accredited investors).
Accredited Investor	Individual: income \geq Rs.2Cr OR net worth \geq Rs.7.5Cr. Body corporate: net worth \geq Rs.50Cr. Ticket size Rs.25L.

Skin-in-Game	Manager/Sponsor: min 2.5% of corpus or Rs.5Cr (lower). Cat III: min 5% or Rs.10Cr (lower). Cannot waive management fee.
Category I AIF	Invests in socially/economically desirable sectors (start-ups, SMEs, infra, social ventures). Govt incentives available.
Category II AIF	PE funds, debt funds — no special incentives; no leverage beyond operational needs. Most mainstream AIFs.
Category III AIF	Hedge funds, complex strategies. Uses leverage including listed/unlisted derivatives. Highest regulatory requirements.
Venture Capital Fund	Cat I. Invests in unlisted securities of start-ups and early-stage ventures — tech, IP, new business models.
Angel Fund	Sub-category of VCF (Cat I). Raises from angel investors. Angel: net tangible assets ≥ Rs.2Cr + experience.
Private Equity Fund	Cat II. Equity/equity-linked instruments. Later-stage financing of established businesses needing scaling.
Debt Fund	Cat II. Private debt (mezzanine, leveraged loans, distressed debt). Illiquidity is the defining feature.
Hedge Fund	Cat III. Complex/diverse strategies; may use leverage and listed/unlisted derivatives.
Social Impact Fund	Cat I. Invests in social ventures — trusts, Section 8 cos, microfinance institutions.
Special Situations Fund	Cat I. Invests in distressed/special assets; may act as resolution applicant under IBC 2016.
Infrastructure Fund	Cat I. Invests in SPVs engaged in infra projects. High illiquidity; long gestation periods.
Illiquidity Premium	Extra return earned by AIF investors for accepting locked-in capital over long investment horizons.

■ MCQ PRACTICE — Chapter 13 — Alternative Investment Funds

10 Questions | Answers shown below each question

1 What is the defining characteristic that distinguishes Alternative Investments from Traditional Investments?

- a) Higher returns guaranteed by government or regulatory backing
- b) Illiquidity — not readily convertible to cash; off-market or complex structures with no ready exit**
- c) Availability to general public through exchange platforms and open-ended redemption
- d) Regulated by RBI instead of SEBI, making them safer than exchange-traded securities

✓ **Answer: b) Illiquidity — not readily convertible; off-market or complex structures**

Traditional investments are characterised by **liquidity** — stocks can be sold on exchange, open-ended MFs can be redeemed anytime. The essential characteristic of **alternative investments is illiquidity** — they are either off-market investments (unlisted equity, private debt) or complex structures without a ready secondary market. Investors are compensated for this illiquidity through potentially higher returns (illiquidity premium). This illiquidity restricts AIFs to sophisticated investors who can afford to lock in capital for extended periods.

2 Under SEBI AIF Regulations, what is the minimum corpus required per scheme of an Alternative Investment Fund?

- a) Rs.5 crore — same as minimum net worth for a Portfolio Manager
- b) Rs.10 crore — minimum to attract institutional investors into the scheme
- c) Rs.20 crore — mandatory minimum corpus for each AIF scheme**
- d) Rs.100 crore — required to ensure adequate diversification across investee companies

✓ Answer: c) Rs.20 crore — mandatory minimum corpus per AIF scheme

SEBI mandates that **each scheme of an AIF must have a minimum corpus of Rs.20 crore**. This ensures sufficient scale to build a diversified portfolio and justify the operational costs of running an alternative investment structure. The Rs.20 crore minimum corpus is separate from the minimum investment per investor (Rs.1 crore for general investors). A single AIF may run multiple schemes, each needing to independently meet the Rs.20 crore threshold.

3 A Hedge Fund falls under which category of AIF under SEBI regulations?

- a) Category I — as it provides economic benefits through complex market strategies
- b) Category II — as it invests in equity and debt without leverage like PE funds
- c) Category III — as it employs complex/diverse trading strategies and may use leverage through derivatives**
- d) Category IV — a special SEBI category created specifically for leveraged trading funds

✓ Answer: c) Category III — complex strategies, leverage through derivatives

SEBI classifies **Hedge Funds as Category III AIFs**. Category III is defined as AIFs that employ **diverse or complex trading strategies** and may employ **leverage** including through investments in listed or unlisted derivatives. Hedge funds exactly fit this definition — they use sophisticated long/short strategies, derivatives, leverage, and complex risk management tools. Category III AIFs have the strictest skin-in-game requirements (Manager/Sponsor must maintain min 5% of corpus or Rs.10Cr, whichever is lower).

4 What is the maximum number of investors allowed in a single AIF scheme?

- a) 100 investors — to ensure the fund remains truly exclusive and private
- b) 500 investors — standard limit for PMS and similar managed accounts
- c) 1,000 investors — per SEBI AIF Regulations via private placement only**
- d) No limit — AIFs can accept investors freely as long as each invests Rs.1 crore

✓ Answer: c) 1,000 investors — via private placement only per SEBI regulations

SEBI AIF Regulations specify that **no scheme of an AIF shall have more than 1,000 investors**. This is consistent with the Companies Act, 2013 provisions (if structured as a company). Funds can only be solicited through **private placement** — not from the general public. This limit reinforces the "privately pooled" nature of AIFs and ensures they remain accessible only to sophisticated investors who understand the risks of complex, illiquid investment structures.

5 An investor wants to invest in a fund that provides early-stage financing to technology startups. Which type of AIF is most suitable?

- a) Category III Hedge Fund — best for volatile high-growth technology sectors
- b) Category II Private Equity Fund — specialises in equity investment in established companies
- c) Category I Venture Capital Fund — invests in unlisted securities of start-ups and early-stage ventures**
- d) Category II Debt Fund — provides mezzanine financing to technology companies

✓ **Answer: c) Category I Venture Capital Fund — start-ups and early-stage tech investments**

A **Venture Capital Fund (VCF)** under Category I AIF is specifically designed to invest in **unlisted securities of start-ups and early-stage ventures** involved in new products, services, technology, IP, or new business models. It is the first stage of institutional financing after the angel stage. Technology-focused, asset-light businesses are the primary targets. Category I AIFs receive government incentives/concessions as they are considered economically and socially desirable. Private Equity funds focus on later-stage, established businesses — not start-ups.

6 What is the minimum continuing interest that a Manager or Sponsor must maintain in a Category III AIF?

- a) 1% of corpus or Rs.1 crore (whichever is lower)
- b) 2.5% of corpus or Rs.5 crore (whichever is lower)
- c) 5% of corpus or Rs.10 crore (whichever is lower)**
- d) 10% of corpus or Rs.25 crore (whichever is lower)

✓ **Answer: c) 5% of corpus or Rs.10 crore (whichever is lower)**

Skin-in-game requirements differ by category: For **Category I & II AIFs**, Manager/Sponsor must maintain continuing interest of min 2.5% of corpus OR Rs.5 crore (lower). For **Category III AIFs** (Hedge Funds), the requirement is stricter at **min 5% of corpus OR Rs.10 crore (lower)**. This higher requirement for Cat III reflects the greater complexity and risk of leveraged, derivative-heavy strategies. Crucially, this interest cannot be satisfied through waiver of management fees — actual capital must be at risk.

7 Which of the following BEST describes the role of a Special Situations Fund?

- a) It invests only in listed equity securities during periods of high market volatility
- b) It provides early-stage venture financing for technology companies during special economic windows
- c) It invests in special situation assets and may act as a resolution applicant under IBC 2016**
- d) It is a Category II fund that specialises in distressed listed company bonds only

✓ **Answer: c) Invests in special situation assets; may act as resolution applicant under IBC 2016**

A **Special Situations Fund** is a Category I AIF that invests in "special situation assets" as per its investment objectives. Its unique distinction is the ability to **act as a resolution applicant under the Insolvency and Bankruptcy Code (IBC), 2016**. This means it can participate in insolvency proceedings to acquire distressed companies, provide turnaround capital, or facilitate debt resolution. These funds are critical to India's credit market health and IBC ecosystem, providing institutional capital for companies undergoing financial distress or restructuring.

8 What is the minimum investment amount for an "Accredited Investor" in an AIF?

- a) Rs.10 lakh — significantly lower to broaden AIF access to upper middle class investors
- b) Rs.25 lakh — reduced ticket size for investors meeting specific income/net worth criteria**
- c) Rs.50 lakh — same as the minimum PMS ticket for qualifying investors
- d) Rs.1 crore — the accredited investor threshold is same as general AIF minimum

✓ **Answer: b) Rs.25 lakh — for investors meeting SEBI's accreditation income/net worth criteria**

SEBI introduced the concept of **Accredited Investors** who can invest in AIFs at a reduced ticket size of **Rs.25 lakh** (vs the standard Rs.1 crore). Eligibility for individuals/HUFs/family trusts: Annual income \geq Rs.2Cr; OR Net worth \geq Rs.7.5Cr (with \geq Rs.3.75Cr in financial assets); OR Income \geq Rs.1Cr AND net worth \geq Rs.5Cr (with \geq Rs.2.5Cr financial assets). Body corporates/trusts: net worth \geq Rs.50Cr. Adoption by AIFs is optional — not all AIFs offer the Rs.25L ticket size even if investors qualify.

9 Category I and Category II AIFs can invest a maximum of what percentage in a single investee company?

- a) 10% of investable funds — same as the limit for Category III AIFs
- b) 20% of investable funds — standard concentration limit for all AIF categories
- c) 25% of investable funds — for Category I and II; 10% for Category III**
- d) 50% of investable funds — permitted for focused sector Category I funds

✓ **Answer: c) 25% for Category I & II; 10% for Category III AIFs**

SEBI AIF Regulations prescribe different single-company concentration limits: **Category I and II AIFs** can invest a maximum of **25% of investable funds** in any single investee company (directly or via other AIF units). **Category III AIFs** have a tighter limit of **10% of investable funds** in any single investee company. The stricter limit for Cat III reflects their complex, leveraged strategies where concentration risk can be amplified. These limits apply to investments either directly or through co-investment structures.

10 Why are Alternative Investments considered valuable in a portfolio management context beyond just return enhancement?

- a) They are guaranteed by SEBI against capital loss, providing safety not available in traditional investments
- b) They provide diversification, illiquidity premium, and access to non-correlated asset classes that improve risk-adjusted returns**
- c) They are always more liquid than mutual funds and stocks, enabling faster portfolio rebalancing
- d) They require no regulatory compliance, reducing administrative costs for portfolio managers

✓ **Answer: b) Diversification, illiquidity premium, non-correlated assets improving risk-adjusted returns**

The rationale for AIFs extends well beyond return enhancement. Key benefits: (1) **Diversification** — low correlation with stocks/bonds reduces overall portfolio volatility; (2) **Illiquidity Premium** — investors earn additional returns for accepting locked-in capital; (3) **Access to unique opportunities** — start-up financing, private debt, infrastructure not accessible through public markets; (4) **Inflation hedge** — real assets within AIFs protect against inflation. Globally, major investors (pension funds, sovereign wealth funds, endowments) allocate significant portions to alternatives precisely for these diversification and return enhancement benefits.