

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

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EXAMINATION DETAILS

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

Total marks	100
Duration	2 hours
Pass mark	60
Negative marking	10 percent of the marks assigned to a question.

WEIGHTAGE

Chapter No.	Chapter Name	Weightage (%)
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NISM-Series-XIX-B: Alternative Investment Funds (Category III) Distributors

Chapter 1 – Overview of Alternative Investments

Alternative Investments: Investments other than traditional assets like stocks, bonds, and cash, catering to sophisticated investors like HNIs and institutions.

Traditional Investments: Include listed stocks, bonds, mutual funds, and ETFs, characterized by high liquidity through capital market trading.

Illiquidity: Essential characteristic of alternative investments, making them less convertible to cash due to off-market nature or complex structures.

Dual Class Investments: Structures with illiquid underlying assets but liquid instruments, like REITs or InvITs, listed on exchanges.

AIF Definition: SEBI defines AIF as a privately pooled investment vehicle from select investors, excluding mutual funds, family trusts, or RBI-regulated funds.

Investors in AIFs: Include pension funds, insurance companies, endowment funds, investment banks, family offices, HNIs, and fund managers.

Venture Capital: Direct investment in start-ups or early-stage companies with high growth potential but high risk due to complex technologies.

Private Equity: Investments in unlisted companies, often later-stage, including buyouts or leveraged buyouts for higher returns.

Hedge Funds: Pooled vehicles investing in diverse assets like derivatives, using complex strategies and leverage, taking long and short positions.

Real Estate Investments: Involve financing large projects or REITs, which offer cash flow from rent-yielding properties but carry market and illiquidity risks.

Infrastructure Investments: Investments in InvITs or unlisted infrastructure projects, preferred by low-risk investors like pension funds.

Commodities: Hard commodities (e.g., oil, metals) used as hedges against inflation, unlike soft commodities used in trade.

Other Alternative Assets: Include gems, arts, antiques, film funds, and FinTech platforms offering returns via interest or equity.

Historical Evolution: Alternative investments grew post-Industrial Revolution, with venture capital formalized in the 1950s in the US.

Portfolio Diversification: Modern portfolio theory in the 1950s established diversification benefits, reducing risk through alternative assets.

Small Business Investment Act: Passed in 1958 in the US, it boosted venture capital by providing tax breaks and regulatory support.

Post-2008 Growth: Alternative investments surged after 2008 due to limited returns from traditional assets, per Bain Private Equity Report.

Portfolio Management Role: Alternative investments enhance risk-adjusted returns and diversification for institutional fund managers.

Diversification Benefits: Alternative investments lower portfolio risk through uncorrelated assets, improving overall returns.

High Absolute Returns: Private equity funds score high on generating alpha through off-market strategies.

Reliable Income Streams: Infrastructure funds provide steady cash flows, unlike private equity focused on growth capital.

Complex Structures: Alternative investments require intricate fund setups, making them harder for investors to understand.

Risk-Return Trade-off: Actively managed alternative investments offer better returns but involve higher risks.

Alpha Generation: Off-market strategies in alternative investments aim to generate excess returns over benchmarks.

Illiquidity Risk: Long investment cycles in alternative investments limit liquidity compared to traditional assets.

Professional Support: Complex contractual terms necessitate ongoing professional advice for investors.

Transparency Challenges: Alternative investments are less transparent, complicating risk assessment.

Customized Opportunities: Fund managers create tailored investment options to maximize returns.

Economic Challenges: High valuations, volatile markets, and geopolitical risks impact alternative investment returns.

Technological Disruption: Rapid technological changes make forecasting investment outcomes harder.

Risk Diversification: Alternative investments move beyond traditional avenues to spread risk.

Complex Return Methodologies: Returns in alternative investments use sophisticated calculation methods.

Contractual Risks: Investors face risks from complex agreements in alternative investments.

Market Risks: Alternative investments are exposed to sector-specific and economic volatility.

Entrepreneurial Limitations: Start-ups and unlisted companies face risks from inexperienced management.

Venture Capital Risk: High mortality rates in start-ups make venture capital highly risky.

Private Equity Buyouts: Involve acquiring controlling interests (51% or more) in unlisted companies.

Hedge Fund Leverage: Borrowing at the fund level increases risk but aims for higher arbitrage returns.

REITs Liquidity: Listed REITs offer liquidity, placing them in the dual investment category.

InvITs Stability: Infrastructure Investment Trusts provide predictable cash flows for low-risk investors.

Commodities as Hedges: Precious metals and oil serve as inflation hedges in alternative portfolios.

FinTech Growth: Indian FinTech platforms offer alternative investment opportunities via equity or interest.

Portfolio Assessment: Risk diversification strategies evaluate alternative assets on a portfolio basis.

Institutional Investors: Large funds like pension and endowment funds drive alternative investment demand.

Early-Mover Returns: Investing early in new asset classes can yield stellar returns.

Geo-Political Risks: Trade wars and global economic shifts increase uncertainty in alternative investments.

High Valuations: Emerging markets face challenges from inflated asset prices.

Regulatory Challenges: Evolving regulations impact alternative investment strategies.

Venture Capital in India: Defined by DPIIT as start-ups under 10 years with turnover below INR 100 crore.

Private Equity Scope: Includes equity, preference shares, debt, or mezzanine capital in unlisted firms.

Hedge Fund Strategies: Use arbitrage, short selling, and derivatives for speculative returns.

Real Estate PE Funds: Provide growth capital to real estate companies or project-specific SPVs.

Alternative Debt Funds: Finance high-yield debt and structured products like REITs and InvITs.

Post-Dotcom Recovery: The alternative investment industry rebounded after 2001, driven by strong IPO markets.

Control Acquisitions: Private equity funds increasingly focus on buyouts in the global M&A market.

Investment Strategy Evolution: Institutional investors shifted to portfolio-based risk assessment in the 1970s.

Risky Asset Inclusion: Small-cap stocks, unlisted bonds, and structured products became portfolio staples.

Venture Capital Origins: Began with wealthy individuals financing risky ventures post-Industrial Revolution.

Merchant Banks: Early institutional financiers in the UK laid the foundation for venture capital.

Fund Management Growth: The 1970s and 1980s saw significant expansion in professional fund management.

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

Hedge Fund Origins: First hedge fund launched in 1949 by A.W. Jones & Co., using incentive fees, short selling, and leverage.

Indian Capital Markets: Significant growth in the 1990s, with portfolio managers and mutual fund regulations shaping asset management.

Foreign Hedge Funds: Invested in India via offshore jurisdictions or ODIs issued by FIIs, holding 5% of FII assets by March 2004.

Eurekahedge Index: Tracks 15 India-focused hedge funds, showing consistent returns despite the 2008 financial crisis.

Offshore Restrictions: Hedge funds couldn't market in India pre-2012 due to public offering rules and RBI restrictions.

Liberalised Remittance Scheme: Introduced in 2004, allowing Indian residents to invest up to USD 250,000 in foreign securities by 2015.

FII Registration: Hedge funds could register as FIIs under SEBI with conditions like regulated advisors and 20% institutional corpus.

SEBI AIF Regulations: Introduced in 2012, classifying hedge funds as Category III AIFs with complex trading strategies.

Consolidation Phase: 2012–2019 saw growth in Category III AIFs, driven by reforms and market developments.

Ultra-Rich Investors: Indian billionaires increasingly invested in Category III AIFs during the consolidation phase.

RBI Liberalization: 2015 FEMA notification allowed foreign investors, including NRIs, to invest in AIFs.

AIPAC Recommendations: Led by Narayan Murthy, aimed to improve tax regimes and attract domestic institutional investors.

TER Rationalization: SEBI amendments encouraged mutual fund managers to launch Category III AIFs with flexible fee structures.

Performance-Based Fees: Category III AIF managers can charge fees on returns above a hurdle rate, unlike mutual funds.

Operational Guidelines: SEBI monitors Category III AIFs for compliance with leverage and prudential norms.

Investor Reporting: Category III AIFs provide periodic updates on funds raised, exposure, and leverage.

Commodity Derivatives: Category III AIFs expanded into exchange-traded commodity futures and options.

Special Situations: Some Category III AIFs focus on merger arbitrage, buybacks, and convertible arbitrage.

Venture Capital Fund: Invests in unlisted start-ups with new products, services, or business models, including angel funds.

Angel Fund: A sub-category of VCF, raising funds from angel investors with specific net worth or experience criteria.

Private Equity Fund: Invests in equity or equity-linked instruments of later-stage unlisted companies.

Debt Fund: Invests in listed or unlisted debt securities, including securitized debt instruments.

Infrastructure Fund: Focuses on unlisted securities or debt of infrastructure projects or SPVs.

SME Fund: Invests in unlisted or listed SME securities on SME exchanges.

Hedge Fund Definition: Employs diverse, complex trading strategies in securities, including derivatives.

Social Impact Fund: Invests for social and environmental impact alongside financial returns.

Start-Up Criteria: DPIIT defines start-ups as companies under 10 years with turnover below INR 100 crore.

Venture Capital Undertaking: A domestic unlisted company at the time of investment.

Angel Investor Criteria: Individuals with INR 2 crore net tangible assets or corporates with INR 10 crore net worth.

Private Equity Scope: Includes growth capital, buyouts, and mezzanine financing for established firms.

Debt Fund Types: Include venture debt and distressed debt financing under IBC proceedings.

Infrastructure Fund Risks: High illiquidity and long gestation periods in project implementation.

SME Fund Focus: Targets small and medium enterprises as per the MSME Development Act.

Category III AIF Suitability: Suitable for HNIs and institutions with high risk appetite due to complex strategies.

Market Growth: Category III AIFs grew by targeting mid-cap and small-cap securities with hedging strategies.

Regulatory Framework: SEBI's 2012 regulations provided clarity and structure for AIF growth.

Foreign Investment: Category III AIFs with foreign sponsors are treated as foreign investments.

Performance Fees: Paid on additional returns above a reference hurdle rate, enhancing manager flexibility.

Domestic Investor Base: Includes banks, insurance companies, pension funds, and family offices.

Hedge Fund Characteristics: Include leverage, performance fees, periodic redemptions, and derivative use.

Category I AIFs: Include VCFs, angel funds, SME funds, and infrastructure funds, focusing on economic growth.

Category II AIFs: Include private equity and debt funds without leverage or specific economic benefits.

Category III AIFs: Use complex strategies, leverage, and invest in listed/unlisted securities.

Comparison of Categories: Category III AIFs have higher risk and flexibility compared to Category I and II.

Investor Risk Profiling: Essential for matching Category III AIFs to investor risk tolerance.

Market Status: Category III AIFs have grown significantly, with USD 22 trillion in global AUM by 2023.

Hedging Strategies: Used in Category III AIFs for risk management in volatile markets.

Mid-Cap Investments: Category III AIFs target mid-cap and small-cap securities for higher returns.

RBI Circulars: Governed foreign investment limits and marketing by Indian banks for offshore funds.

Tax Regime Improvements: Boosted domestic institutional investment in Category III AIFs.

Fund Manager Experience: FII-registered hedge funds required managers with 3 years of experience.

Offshore Fund Challenges: Limited by high minimum investment thresholds for Indian investors.

Mutual Fund Limits: Restricted to 10% of net assets for foreign securities investment.

Listed Company Investments: Permitted in foreign listed companies, expanding investment options.

Hedge Fund Identification: Based on IOSCO criteria like leverage and complex strategies.

Regulatory Restrictions: Pre-2012, hedge funds faced barriers due to capital account convertibility.

Category III AIF Flexibility: Allows diverse asset investments and speculative strategies.

Investor Education: Distributors must educate investors on risks and strategies of Category III AIFs.

Market Opportunities: Category III AIFs tap into new opportunities like commodity derivatives.

Consolidation Drivers: Government reforms and market developments fueled AIF growth post-2012.

Fund House Growth: New fund houses launched Category III AIFs for wealthy investors.

Global Financial Crisis: Impacted hedge fund performance, but recovery was strong post-2008.

Chapter 3 – Introduction to Category III AIF Ecosystem

Category III AIF Investments: Include listed/unlisted securities, derivatives, and commodity futures.

Leverage Usage: Category III AIFs use borrowing to enhance returns, increasing risk.

Complex Strategies: Employ arbitrage, short selling, and derivatives for speculative gains.

Risk Management Tool: Category III AIFs hedge market risks through long and short positions.

Fund Structure: Typically set up as trusts, LLPs, or companies under SEBI regulations.

Service Providers: Include custodians, valuers, and auditors ensuring operational compliance.

Investment Objectives: Aim for alpha generation through diverse, high-risk strategies.

Hedge Fund Characteristics: High leverage, performance fees, and complex risk patterns.

Global Market Overview: Hedge funds globally manage significant AUM, with India emerging.

NAV Computation: Net Asset Value reflects the fund's market value, critical for performance.

Valuation Techniques: Use market, income, or cost approaches for asset valuation.

Investor Base: HNIs, institutions, and accredited investors with high risk tolerance.

Regulatory Oversight: SEBI monitors leverage, concentration, and reporting norms.

Performance Benchmarking: Compares fund returns to indices like Eurekahedge.

Illiquidity Risk: Long holding periods limit quick exits from investments.

Market Risk: Exposure to volatility in securities and commodity markets.

Derivatives Use: Includes futures, options, and swaps for hedging and speculation.

Commodity Futures: Category III AIFs invest in exchange-traded commodity contracts.

Special Situations: Focus on merger arbitrage, buybacks, and delistings for returns.

Portfolio Diversification: Reduces risk through uncorrelated asset investments.

Fund Manager Role: Actively manages investments to achieve high risk-adjusted returns.

Accredited Investors: Exempt from certain SEBI regulations, enabling flexibility.

Fee Structure: Includes management fees and performance-based fees above hurdle rates.

Investor Reporting: Periodic updates on fund performance, leverage, and exposures.

SEBI Regulations: Govern Category III AIF operations, ensuring investor protection.

Hedge Fund Strategies: Include long-short, global macro, and convertible arbitrage.

Risk Disclosure: Mandatory for transparency and investor decision-making.

Fund Tenure: Close-ended funds have fixed durations, impacting liquidity.

Private Placement: Funds raised from select investors, not the general public.

Due Diligence: Investors assess fund strategy, risks, and manager expertise.

Tax Implications: Vary by fund structure and investor jurisdiction (domestic/IFSC).

Distributors' Role: Facilitate investor onboarding and provide ongoing support.

Investment Restrictions: SEBI limits leverage and concentration to manage risks.

Fund Governance: Involves trustees, sponsors, and managers for accountability.

Global Hedge Funds: Use diverse assets and strategies, influencing Indian Category III AIFs.

Performance Metrics: Include mean return, Sharpe ratio, and downside risk.

Hurdle Rate: Minimum return threshold for performance fee calculations.

Skin-in-the-Game: Managers invest in the fund to align interests with investors.

Operational Norms: SEBI guidelines ensure standardized fund operations.

Commodity Options: Category III AIFs use options for speculative strategies.

Merger Arbitrage: Exploits price gaps during corporate mergers or acquisitions.

Convertible Arbitrage: Combines long convertible bonds with short equity positions.

Event-Driven Strategies: Focus on corporate events like restructurings or buybacks.

Fund Transparency: Limited compared to traditional investments, increasing risk.

High-Risk Profile: Suitable for investors with high risk appetite and long horizons.

Regulatory Compliance: Adherence to SEBI's operational and reporting norms.

Investor Education: Distributors must explain complex strategies and risks.

Fund Lifecycle: Includes first close, final close, and eventual winding-up.

Leverage Risks: Borrowing increases potential losses if investments underperform.

Portfolio Monitoring: Active oversight by managers to optimize returns.

Third-Party Valuers: Ensure independent and accurate asset valuations.

Fund Expenses: Include management fees, operational costs, and taxes.

Market Volatility: Impacts Category III AIF performance due to speculative strategies.

Investor Suitability: Assessed based on risk profiling and financial goals.

Fund Reporting: SEBI mandates periodic disclosures on performance and risks.

Global Macro Strategy: Bets on macroeconomic trends across markets.

Equity Market Strategies: Include long-short and market-neutral approaches.

Credit Default Swaps: Used for hedging credit risks in Category III AIFs.

Fund Closure: Involves liquidation or distribution of assets at tenure end.

Investor Grievances: Addressed through SEBI's investor charter and reporting.

Compliance Test Reporting: Ensures adherence to SEBI regulations.

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

Fund Structures: Category III AIFs can be trusts, LLPs, or companies under SEBI.

Trust Structure: Common for AIFs, with a trustee overseeing investor interests.

LLP Structure: Offers flexibility in management and tax pass-through benefits.

Company Structure: Used for structured governance but less common for AIFs.

Sponsor Role: Provides initial capital and ensures fund credibility.

Investment Manager: Makes investment decisions and manages fund operations.

Custodian: Holds and safeguards fund assets, mandatory for Category III AIFs.

Third-Party Valuers: Provide independent valuations for accurate NAV reporting.

Auditors: Ensure financial transparency and compliance with regulations.

Distributors: Facilitate investor onboarding and marketing of AIF units.

Fund Administrator: Manages back-office operations like record-keeping.

Trustee Responsibilities: Ensure compliance with SEBI and protect investor interests.

Manager Expertise: Critical for executing complex Category III AIF strategies.

Service Provider Roles: Enhance operational efficiency and regulatory compliance.

Private Placement Memorandum: Outlines fund strategy, risks, and terms.

Contribution Agreement: Defines investor terms and commitments.

SEBI Registration: Mandatory for Category III AIFs to operate legally.

Fund Governance: Involves oversight by trustees, sponsors, and managers.

Leverage Limits: SEBI caps borrowing to manage systemic risks.

Investor Classes: Different unit classes may have varying fees or rights.

Fund Tenure: Close-ended funds have fixed lifespans, typically 5–7 years.

First Close: Marks the initial capital commitment, starting fund operations.

Final Close: Last date for accepting investor commitments.

Dematerialisation: AIF units must be held in demat form for transparency.

Direct Plan: Investors bypass distributors, reducing commission costs.

Distributor Plan: Involves commissions, impacting investor returns.

Fund Expenses: Include management fees, setup costs, and operational expenses.

Risk Management: Service providers ensure compliance with SEBI risk norms.

Investor Reporting: Periodic updates on NAV, performance, and risks.

Tax Pass-Through: Trust structures allow income to pass directly to investors.

Custodian Duties: Include safekeeping assets and verifying transactions.

Valuation Policies: Standardized by SEBI for consistent NAV calculations.

Fund Documentation: Includes PPM, contribution agreements, and KYC forms.

Operational Norms: SEBI guidelines ensure standardized fund operations.

Compliance Officer: Mandatory for AIF managers to ensure regulatory adherence.

Fund Closure: Involves liquidation or in-specie distribution of assets.

Investor Charter: SEBI mandates disclosures for investor protection.

Accredited Investors: Face fewer regulatory restrictions, enhancing flexibility.

Fund Manager Liability: Accountable for investment decisions and compliance.

Service Provider Fees: Impact fund expenses and investor returns.

Regulatory Framework: SEBI's 2012 AIF regulations govern fund structures.

Skin-in-the-Game: Managers invest in the fund to align interests.

Fund Setup Costs: Include legal, registration, and administrative expenses.

Investor Due Diligence: Assesses fund strategy, manager track record, and risks.

Fund Transparency: Enhanced by service providers' independent oversight.

Leverage Strategy: Borrowing used to amplify returns but increases risk.

Tax Implications: Vary by fund structure (e.g., trust vs. LLP).

SEBI Oversight: Ensures compliance with operational and prudential norms.

Fund Lifecycle: Includes setup, investment, and winding-up phases.

Investor Onboarding: Distributors handle KYC and documentation processes.

Manager Qualifications: SEBI requires experienced managers for Category III AIFs.

Fund Reporting: Includes leverage, concentration, and performance metrics.

Third-Party Oversight: Valuers and auditors ensure independent checks.

Fund Jurisdiction: Impacts tax and regulatory treatment (e.g., IFSC vs. domestic).

Investor Rights: Defined in contribution agreements and PPM disclosures.

Operational Efficiency: Service providers streamline fund administration.

Fund Risk Factors: Include market, illiquidity, and regulatory risks.

Manager Fiduciary Duty: Act in the best interests of investors.

Fund Benchmarking: Compares performance to indices like BSE or Eurekahedge.

Investor Grievances: Addressed through SEBI's structured mechanisms.

Fund Liquidation: Follows SEBI guidelines for orderly winding-up.

Chapter 5 – Regulatory Framework

SEBI AIF Regulations: Introduced in 2012, govern Category III AIF operations.

Registration Process: Mandatory for Category III AIFs, involving SEBI approval.

Accredited Investors: Exempt from certain restrictions, enhancing flexibility.

Investment Conditions: Minimum investment of INR 1 crore, except for employees.

Fund Raising: Done via private placement, not public offerings.

Private Placement Memorandum: Mandatory document outlining fund details and risks.

First Close: Marks the start of fund operations with initial capital.

Final Close: Deadline for accepting investor commitments.

Dematerialisation: AIF units must be held in demat form for transparency.

Open-Ended vs. Close-Ended: Category III AIFs are typically close-ended.

Listing of Funds: Close-ended funds can be listed on exchanges for liquidity.

Direct vs. Distributor Plans: Direct plans avoid commission costs for investors.

Investment Limits: SEBI caps investments in single entities to manage risk.

Concentration Limits: Restrict overexposure to single securities or sectors.

Leverage Norms: SEBI limits borrowing to control systemic risks.

Credit Default Swaps: Category III AIFs can use CDS for hedging credit risks.

General Obligations: Include transparency, investor protection, and compliance.

Winding-Up Process: Follows SEBI guidelines for orderly fund closure.

Investor Charter: Mandates disclosures for investor awareness and protection.

Compliance Test Reporting: Ensures adherence to SEBI regulations.

FATCA/CRS Compliance: AIFs must report foreign investor details under global standards.

Insider Trading Regulations: Prohibit sharing unpublished price-sensitive information.

Anti-Money Laundering: AIFs comply with PMLA for KYC and reporting.

FEMA Regulations: Govern foreign investments in Category III AIFs.

ICDR Regulations: Apply to AIF investments in listed securities.

Stewardship Code: Mandates responsible investment in listed equities.

Fund Manager Duties: Include fiduciary responsibility and regulatory compliance.

Investor Eligibility: Restricted to HNIs, institutions, and accredited investors.

Fund Tenure: Close-ended funds have fixed durations, typically 5–7 years.

Risk Disclosures: Mandatory in PPM to inform investors of potential risks.

Operational Norms: SEBI guidelines ensure standardized fund operations.

Prudential Norms: Limit leverage and concentration to protect investors.

Reporting Requirements: Include periodic disclosures on performance and risks.

Custodian Role: Mandatory for safekeeping and verifying fund assets.

Valuation Norms: SEBI standardizes valuation for consistent NAV reporting.

Fund Governance: Involves trustees, sponsors, and managers for accountability.

Investor Grievances: Addressed through SEBI's structured mechanisms.

Fund Transparency: Enhanced by mandatory disclosures and reporting.

Tax Compliance: AIFs adhere to domestic and IFSC tax regulations.

KYC Requirements: Mandatory for investor onboarding under PMLA.

Fund Manager Experience: SEBI requires proven expertise for registration.

Regulatory Penalties: Apply for non-compliance with SEBI regulations.

Fund Closure: Involves liquidation or in-specie distribution per SEBI rules.

Accreditation Agencies: Verify investor eligibility for accredited status.

Foreign Investment Rules: Governed by FEMA and RBI circulars.

Fund Documentation: Includes PPM, contribution agreements, and KYC forms.

SEBI Circulars: Provide detailed guidelines on AIF operations and compliance.

Investor Protection: Central to SEBI's regulatory framework for AIFs.

Fund Leverage: Monitored to prevent excessive risk-taking.

Compliance Officer: Mandatory for AIF managers to ensure adherence.

Due Diligence: Investors assess fund strategy, risks, and compliance.

Fund Expenses: Disclosed in PPM, impacting investor returns.

Tax Pass-Through: Trust structures allow income to pass directly to investors.

Fund Jurisdiction: Impacts regulatory and tax treatment (e.g., IFSC).

Manager Liability: Accountable for breaches of SEBI regulations.

Investor Reporting: Includes NAV, performance, and leverage details.

Fund Benchmarking: Compares performance to relevant indices.

Regulatory Updates: SEBI amendments refine AIF operations and compliance.

Fund Risk Management: Involves leverage and concentration controls.

Investor Rights: Defined in contribution agreements and PPM.

Fund Liquidation: Follows SEBI's structured process for winding-up.

Chapter 6 – Fees Structure, Fund Performance and Benchmarking

Management Fees: Fixed annual fees charged by Category III AIF managers.

Performance Fees: Paid on returns above a hurdle rate, incentivizing managers.

Hurdle Rate: Minimum return threshold for performance fee calculations.

Catch-Up Provisions: Allocate additional returns to managers post-hurdle rate.

Fund Expenses: Include setup, operational, and service provider costs.

Total Expense Ratio: Impacts investor returns, rationalized by SEBI for fairness.

Performance Measurement: Uses metrics like mean return, Sharpe ratio, and alpha.

Mean Return: Average historical return, indicating past fund performance.

Sharpe Ratio: Measures risk-adjusted returns, higher values indicate better performance.

Alpha Generation: Excess return over benchmark, key for Category III AIFs.

Downside Risk: Probability of loss due to declining asset prices.

Performance Benchmarking: Compares fund returns to indices like BSE or Eurekahedge.

Reference Hurdle Rate: Baseline for calculating additional returns for fees.

Fund Transparency: Enhanced by disclosing fees and performance metrics.

Investor Returns: Impacted by fees, taxes, and fund performance.

Risk-Adjusted Returns: Critical for evaluating Category III AIF efficiency.

Benchmark Indices: Include BSE, Nifty, or Eurekahedge for comparison.

Fee Disclosure: Mandatory in PPM for investor transparency.

Fund Performance Tools: Include IRR, CAGR, and volatility measures.

Skin-in-the-Game: Managers invest in the fund to align interests.

Performance Reporting: Periodic updates on NAV, returns, and risks.

Leverage Impact: Increases potential returns but also amplifies risks.

Fund Costs: Include legal, custodial, and valuation expenses.

Investor Expectations: Focus on high absolute returns and diversification.

Tax Impact: Fees and taxes reduce net investor returns.

Performance Metrics: Used to assess manager effectiveness and fund success.

Volatility Measures: Indicate risk levels in Category III AIF investments.

Return Calculations: Use complex methodologies due to diverse strategies.

Fund Benchmarking: Ensures alignment with market performance standards.

Investor Reporting: Includes fee structure and performance breakdowns.

Management Fee Structure: Typically 1–2% of AUM annually.

Performance Fee Structure: Often 20% of returns above hurdle rate.

Hurdle Rate Importance: Ensures managers are rewarded for outperformance.

Fund Risk Profile: High due to leverage and complex strategies.

Performance Consistency: Evaluated through historical return trends.

Benchmark Selection: Must align with fund's investment strategy.

Fee Impact: High fees can erode investor returns over time.

Return Attribution: Analyzes sources of fund returns (e.g., alpha, beta).

Investor Due Diligence: Assesses fee structure and performance history.

Fund Transparency: Enhanced by SEBI-mandated performance disclosures.

Risk Metrics: Include standard deviation and downside risk for evaluation.

Performance Fee Triggers: Linked to achieving specific return thresholds.

Fund Expenses Disclosure: Mandatory for investor awareness.

Manager Incentives: Performance fees align manager and investor interests.

Benchmark Relevance: Ensures fair comparison with similar funds.

Return Volatility: Higher in Category III AIFs due to speculative strategies.

Fund Performance Drivers: Include strategy, leverage, and market conditions.

Investor Protection: SEBI mandates clear fee and performance reporting.

Fund NAV: Reflects current value of assets, critical for performance.

Fee Structure Variations: Differ by unit class and investor type.

Performance Benchmarking Norms: SEBI guidelines ensure standardized comparisons.

Risk-Return Trade-Off: Category III AIFs aim for high returns with high risks.

Fund Manager Expertise: Key to achieving performance targets.

Investor Grievances: Addressed through performance and fee transparency.

Fund Closure Impact: Fees and performance affect final distributions.

Tax Implications: Impact net returns after fee deductions.

Fund Reporting: Includes detailed breakdowns of fees and returns.

Performance Evaluation: Uses both absolute and relative return measures.

Investor Expectations Management: Distributors explain fees and risks.

Fund Success Metrics: Include alpha, Sharpe ratio, and consistent returns.

Chapter 7 – Category III AIF Investment Strategies and Due Diligence Process

Equity Market Strategies: Include long-short, market-neutral, and directional bets.

Long-Short Strategy: Buys undervalued stocks and shorts overvalued ones.

Market-Neutral Strategy: Balances long and short positions to minimize market risk.

Global Macro Strategy: Bets on macroeconomic trends across asset classes.

Convertible Arbitrage: Combines long convertible bonds with short equity positions.

Event-Driven Strategies: Focus on corporate events like mergers or restructurings.

Merger Arbitrage: Exploits price gaps during mergers or acquisitions.

Special Situations: Include buybacks, delistings, and rights offerings.

Due Diligence Process: Investors assess strategy, risks, and manager track record.

Investment Strategy Risks: High due to leverage and complex instruments.

Leverage Usage: Amplifies returns but increases potential losses.

Derivative Strategies: Use futures, options, and swaps for hedging or speculation.

Risk Management: Hedging strategies mitigate market and credit risks.

Fund Manager Expertise: Critical for executing complex strategies.

Investor Suitability: Assessed based on risk appetite and financial goals.

Strategy Disclosure: Mandatory in PPM for investor transparency.

Market Risk: Exposure to volatility in equity and derivative markets.

Illiquidity Risk: Long holding periods limit quick exits.

Portfolio Diversification: Reduces risk through uncorrelated investments.

Performance Metrics: Include alpha, Sharpe ratio, and downside risk.

Fund Transparency: Limited due to complex strategies, requiring due diligence.

Investor Reporting: Includes strategy updates and performance metrics.

Hedging Techniques: Use derivatives to manage downside risks.

Macroeconomic Bets: Global macro strategies target currency and commodity trends.

Arbitrage Opportunities: Exploit price inefficiencies in markets.

Event-Driven Returns: Driven by corporate actions like restructurings.

Due Diligence Scope: Covers strategy, manager, and regulatory compliance.

Risk Profiling: Matches strategies to investor risk tolerance.

Fund Performance: Driven by strategy execution and market conditions.

Leverage Risks: Increase potential losses in adverse markets.

Strategy Flexibility: Category III AIFs can adapt to market changes.

Investor Education: Distributors explain complex strategies and risks.

Fund Benchmarking: Compares strategy performance to relevant indices.

Regulatory Compliance: SEBI monitors strategy implementation and risks.

Manager Track Record: Key factor in investor due diligence.

Investment Restrictions: SEBI limits leverage and concentration.

Portfolio Monitoring: Active oversight to optimize strategy outcomes.

Risk Disclosures: Highlight strategy-specific risks in PPM.

Fund Expenses: Impact returns due to high strategy execution costs.

Tax Implications: Vary by strategy and jurisdiction (e.g., IFSC).

Investor Grievances: Addressed through strategy and performance reporting.

Fund Tenure: Impacts strategy execution due to fixed durations.

Market Volatility: Affects strategy performance in Category III AIFs.

Hedging Effectiveness: Depends on manager skill and market conditions.

Convertible Bonds: Used in arbitrage to balance equity exposure.

Special Situation Risks: Tied to corporate event outcomes.

Global Macro Risks: Linked to unpredictable macroeconomic shifts.

Due Diligence Documentation: Includes PPM, financials, and manager credentials.

Strategy Updates: Material changes must be disclosed to investors.

Fund Governance: Ensures strategy aligns with investor interests.

Investor Rights: Defined in contribution agreements for strategy execution.

Performance Fees: Linked to successful strategy outcomes.

Risk-Return Trade-Off: High returns come with high strategy risks.

Fund Transparency: Enhanced by SEBI-mandated disclosures.

Manager Fiduciary Duty: Ensures strategy prioritizes investor interests.

Investor Onboarding: Distributors explain strategy suitability.

Fund Closure: Strategy impacts final asset distribution.

Regulatory Oversight: SEBI ensures strategy compliance with norms.

Benchmark Selection: Aligns with strategy for fair performance comparison.

Investor Expectations: Managed through clear strategy communication.

Fund Success: Depends on effective strategy execution and market timing.

Chapter 8 – Valuation

Net Asset Value (NAV): Represents the fund's market value, calculated periodically.

Valuation Techniques: Include market, income, and cost approaches for assets.

Market Approach: Uses comparable market transactions for valuation.

Income Approach: Discounts future cash flows to present value.

Cost Approach: Based on replacement or reproduction cost of assets.

NAV Computation: Total assets minus liabilities, divided by units outstanding.

Third-Party Valuers: Provide independent valuations for accuracy.

SEBI Valuation Norms: Standardize valuation for consistent NAV reporting.

Valuation Frequency: Typically quarterly or as per fund policy.

NAV per Unit: Reflects value attributable to each investor's units.

Illiquid Assets: Pose challenges for accurate valuation due to limited market data.

Valuation Policies: Must be disclosed in PPM for transparency.

Fund Performance: NAV is a key metric for evaluating returns.

Regulatory Compliance: SEBI mandates independent valuation for fairness.

Valuation Risks: Errors can impact investor returns and trust.

Market Volatility: Affects valuation of listed securities in the fund.

Income Projections: Critical for income approach in valuing assets.

Cost Adjustments: Account for depreciation or obsolescence in cost approach.

Investor Reporting: Includes NAV updates for performance tracking.

Fund Transparency: Enhanced by standardized valuation practices.

Valuation Disputes: Resolved through third-party valuer expertise.

NAV Accuracy: Critical for performance fee calculations.

Asset Types: Include listed/unlisted securities, derivatives, and commodities.

Valuation Challenges: Complex for illiquid or unlisted assets.

SEBI Oversight: Ensures valuation aligns with regulatory standards.

Fund Expenses: Valuation costs impact overall fund returns.

Investor Due Diligence: Assesses valuation methodology reliability.

Tax Implications: NAV impacts tax calculations on distributions.

Fund Governance: Valuers ensure compliance with SEBI norms.

Leverage Impact: Affects asset valuations due to borrowing costs.

Valuation Disclosure: Mandatory in PPM and periodic reports.

Fund Closure: NAV determines final asset distribution value.

Market Approach Limitations: Less effective for unique or illiquid assets.

Income Approach Risks: Depend on accurate cash flow forecasts.

Cost Approach Use: Common for infrastructure or real assets.

Third-Party Independence: Ensures unbiased valuation outcomes.

NAV Adjustments: Reflect changes in asset values or liabilities.

Valuation Consistency: Critical for investor trust and comparability.

Regulatory Updates: SEBI refines valuation norms for accuracy.

Fund Manager Role: Oversees valuation process for compliance.

Investor Rights: Include access to accurate NAV information.

Valuation Frequency Impact: Affects performance reporting timelines.

Illiquidity Challenges: Require specialized valuation techniques.

Fund Benchmarking: NAV used to compare with benchmark returns.

Valuation Errors: Can lead to investor grievances or legal issues.

Asset Diversification: Impacts complexity of valuation process.

SEBI Circulars: Provide guidelines for standardized valuations.

Fund Performance Metrics: NAV is central to return calculations.

Investor Expectations: Rely on accurate and timely NAV reporting.

Tax Pass-Through: NAV impacts tax liability for trust structures.

Valuation Documentation: Includes valuer reports and methodology.

Fund Risk Management: Valuation accuracy reduces financial risks.

Manager Fiduciary Duty: Ensures fair and transparent valuations.

Investor Grievances: Addressed through clear valuation disclosures.

Fund Jurisdiction: Impacts valuation standards (e.g., IFSC vs. domestic).

Performance Fees: Tied to NAV growth above hurdle rates.

Fund Transparency: Enhanced by independent valuation oversight.

Valuation Costs: Borne by the fund, impacting investor returns.

Regulatory Compliance: Ensures valuation aligns with SEBI standards.

Fund Closure Valuation: Determines final asset value for distribution.

Chapter 9 – Taxation

Tax Regime Comparison: Varies across Category I, II, and III AIFs.

Trust Structure Taxation: Income passes through to investors, avoiding double taxation.

Category III AIF Taxation: Taxed based on income type (capital gains, interest, etc.).

Goods and Services Tax: Applies to management fees and fund services.

Distribution Taxation: Taxed at investor level based on income type.

Unit Transfer Taxation: Capital gains tax applies on transfer of AIF units.

IFSC Taxation: Offers tax benefits for Category III AIFs in GIFT City.

Tax Impact on Performance: Reduces net returns due to tax liabilities.

Pass-Through Status: Trust-based AIFs pass income directly to investors.

Capital Gains Tax: Short-term or long-term based on holding period.

Interest Income Tax: Taxed at investor's slab rate for individuals.

Dividend Taxation: Subject to DDT or investor-level taxation.

Tax Deduction at Source: Applies to certain AIF income distributions.

IFSC Benefits: Lower tax rates and exemptions for offshore investors.

Tax Compliance: AIFs adhere to Income Tax Act and SEBI regulations.

Investor Tax Liability: Varies by investor type (individual, corporate, NRI).

Fund Expenses: Include tax compliance costs, impacting returns.

Tax Reporting: AIFs provide tax statements to investors.

SEBI Oversight: Ensures tax compliance in fund operations.

FEMA Compliance: Governs tax treatment of foreign investments.

Tax Transparency: Disclosed in PPM for investor awareness.

Capital Gains Calculation: Based on NAV at acquisition and disposal.

Tax Pass-Through Benefits: Reduce tax burden for trust-based AIFs.

GST Applicability: Charged on management and performance fees.

Tax Planning: Investors consider tax implications in AIF investments.

Fund Jurisdiction: Impacts tax treatment (e.g., IFSC vs. domestic).

Tax on Redemptions: Treated as capital gains or income based on structure.

Investor Due Diligence: Assesses tax implications before investing.

Tax Reforms: Influence AIF attractiveness for domestic and foreign investors.

Fund Manager Role: Ensures accurate tax reporting and compliance.

Tax on Derivatives: Gains taxed as business income or capital gains.

IFSC Tax Incentives: Encourage offshore AIF setups in GIFT City.

Tax Documentation: Includes TDS certificates and income statements.

Investor Grievances: Addressed through clear tax disclosures.

Fund Closure Taxation: Impacts final distributions to investors.

Tax Pass-Through Mechanism: Simplifies taxation for trust structures.

Capital Gains Exemptions: Available in IFSC for certain transactions.

Tax on Performance Fees: Treated as income for managers.

Investor Tax Profiles: Vary by jurisdiction and investor category.

Fund Transparency: Enhanced by tax-related disclosures in PPM.

Tax on Leverage: Interest costs may impact tax deductions.

Regulatory Compliance: AIFs align with CBDT and SEBI tax norms.

Tax on Unit Transfers: Subject to STT or capital gains tax.

GST Rates: Apply to fund services as per CGST notifications.

Tax Reporting Deadlines: Adhere to Income Tax Act timelines.

Fund Governance: Ensures tax compliance in operations.

Investor Rights: Include access to accurate tax information.

Tax on Distributions: Varies by income type and investor status.

IFSC Tax Framework: Offers simplified tax rules for AIFs.

Tax on Foreign Investors: Governed by FEMA and DTAA provisions.

Fund Performance Impact: Taxes reduce net investor returns.

Tax Due Diligence: Investors assess tax efficiency of AIFs.

Tax on Illiquid Assets: Complex due to valuation challenges.

Fund Manager Liability: Accountable for accurate tax reporting.

Tax Transparency Norms: SEBI mandates clear tax disclosures.

Investor Tax Planning: Considers AIF structure and jurisdiction.

Fund Closure Taxes: Apply to final asset distributions.

Tax on Commodities: Gains taxed as business income or capital gains.

Regulatory Updates: CBDT and SEBI refine AIF tax rules.

Investor Tax Benefits: IFSC offers exemptions for certain investors.

Tax on Fund Expenses: Impacts overall fund profitability.

Chapter 10 – Good Practices

Fund Pitch Book: Outlines investment strategy, risks, and fund terms for investors.

Distributor Role: Facilitates pre- and post-investment services for AIFs.

Client Confidentiality: Distributors must protect investor and fund data.

Code of Conduct: Ensures ethical practices in AIF distribution.

Insurance Importance: Protects AIFs from losses due to errors or key personnel risks.

Pre-Investment Services: Include preparing pitch books and investor meetings.

Post-Investment Services: Facilitate capital calls, reporting, and investor support.

Data Privacy: Distributors implement policies to safeguard confidential data.

Confidentiality Policy: Mandates encryption, NDAs, and secure storage.

Investor Suitability: Distributors match AIFs to investor risk profiles.

Marketing Ethics: Prohibit misleading statements or assured returns.

Distribution Kit: Includes PPM, KYC forms, and fund disclosures.

Investor Education: Distributors explain risks and strategies clearly.

Fund Transparency: Enhanced by disclosing fees, risks, and performance.

Conflict of Interest: Distributors avoid ties with fund managers or sponsors.

Soft Dollar Arrangements: Prohibited to prevent hidden costs to investors.

Pass-Backs: Indirect incentives to investors are unethical and banned.

Investor Grievances: Addressed through clear communication and reporting.

Regulatory Compliance: Distributors adhere to SEBI and PMLA norms.

KYC Processes: Distributors ensure accurate investor documentation.

Professional Indemnity Insurance: Protects AIFs from errors and omissions.

D&O Insurance: Covers losses for directors and officers of the fund.

Key-Man Insurance: Compensates for loss of key executives.

Fund Manager Fiduciary Duty: Prioritizes investor interests in all actions.

Investor Reporting: Includes periodic updates on fund performance.

Fund Governance: Ensures ethical and transparent operations.

Distributor Commissions: Must be disclosed to investors for transparency.

Investor Due Diligence: Supported by distributors with accurate data.

Fund Risk Factors: Disclosed in pitch books and PPM for clarity.

Investor Meetings: Organized by distributors to solicit commitments.

Confidentiality Breaches: Lead to penalties under Data Protection Bill.

Internal Controls: Distributors implement to prevent data theft.

Employee NDAs: Mandatory to protect confidential information.

Data Encryption: Used to secure electronic fund and investor data.

Regulatory Reporting: Distributors provide KYC and tax documents to authorities.

Fund Strategy Disclosure: Material changes must be communicated to investors.

Investor Rights: Include access to accurate fund information.

Ethical Marketing: Avoids negative statements about competing AIFs.

Fund Benchmarking: Distributors explain performance comparisons.

Investor Support: Includes handling capital calls and drawdowns.

Fund Closure Support: Distributors assist in liquidation processes.

Tax Compliance: Distributors provide tax-related documents to investors.

SEBI Regulations: Guide distributor conduct and investor protection.

Fund Performance: Distributors communicate historical and expected returns.

Risk Profiling: Ensures AIF suitability for investor financial goals.

Investor Onboarding: Streamlined by distributors with KYC support.

Fund Transparency Norms: SEBI mandates clear disclosures by distributors.

Confidentiality Measures: Include firewalls and secure document storage.

Distributor Liability: Employees face disciplinary action for breaches.

Investor Trust: Built through ethical and transparent practices.

Fund Manager Updates: Distributors stay informed on manager changes.

Regulatory Updates: Distributors track SEBI and tax law changes.

Investor Education Role: Distributors clarify complex AIF terms.

Fund Documentation: Distributors maintain updated kits for investors.

Marketing Restrictions: Prohibit rebates, gifts, or unethical incentives.

Investor Grievances Redressal: Supported by distributors per SEBI norms.

Fund Suitability Analysis: Based on risk, return, and investor needs.

Distributor Infrastructure: Supports pre- and post-investment processes.

Confidential Data Handling: Employees use secure devices and shred documents.

Code of Conduct Adherence: Ensures alignment with investor interests.

Investor Decision-Making: Distributors avoid misleading or omitting facts.

Important Formulas

Mean Return: $\text{Mean (R)} = \sum R_i / n$

Where R_i = Return achieved in year i , n = Total number of years.

Sharpe Ratio:

$\text{Sharpe Ratio} = (\text{Portfolio Return} - \text{Risk-Free Rate}) / \text{Standard Deviation of Portfolio Return}$

Sortino Ratio: $\text{Sortino Ratio} = (\text{Portfolio Return} - \text{Risk-Free Rate}) / \text{Downside Deviation}$

Treynor Ratio: $\text{Treynor Ratio} = (\text{Portfolio Return} - \text{Risk-Free Rate}) / \text{Beta of Portfolio}$

Information Ratio:

$\text{Information Ratio} = (\text{Portfolio Return} - \text{Benchmark Return}) / \text{Tracking Error}$

Jensen's Alpha:

$\text{Alpha} = \text{Portfolio Return} - [\text{Risk-Free Rate} + \text{Beta} \times (\text{Market Return} - \text{Risk-Free Rate})]$

Net Asset Value (NAV):

$\text{NAV} = (\text{Total Assets} - \text{Total Liabilities}) / \text{Number of Units Outstanding}$

Internal Rate of Return (IRR): $\sum [C_t / (1 + \text{IRR})^t] = 0$

Where C_t = Cash flow at time t , t = Time period.

Compound Annual Growth Rate (CAGR):

$\text{CAGR} = [(\text{Ending Value} / \text{Beginning Value})^{(1/n)}] - 1$

Where n = Number of years.

Value at Risk (VaR): $\text{VaR} = \text{Portfolio Value} \times (\text{Z-Score} \times \text{Standard Deviation})$

Where Z-Score corresponds to confidence level

IMPORTANT NOTE :

1. Attend **ALL** Questions.
2. For the questions you don't know the right answer – Try to eliminate the wrong answers and take a guess on the remaining answers.
3. DO NOT MEMORISE the questions & answers. It's not the right way to prepare for any NISM exam. Good understanding of Concepts is essential.

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All the Best ☺

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94, 1st Floor, TPK Road, Andalpuram, Madurai – 625 003.

Email: akshayatraining@gmail.com

WhatsApp only - 98949 49987