भारतीय प्रतिभूति और विनिमय बोर्ड
Securities and Exchange Board of India

Consultation Paper on review of certain aspects of the framework for valuation of investment portfolio of AIFs

Objective

1. The objective of this consultation paper is to seek comments / views / suggestions from public on the proposals to provide relaxation on the following aspects of the framework for valuation of investment portfolio of AIFs –

    I. Applicability of valuation norms to compute valuation of investment portfolio of AIFs;

    II. Change in valuation methodology and approach being considered as 'material change';

    III. Eligibility criteria of independent valuers to be appointed by AIFs; and,

    IV. Timeline for reporting valuation of investment portfolio by AIFs to Performance Benchmarking Agencies.

Background

2. SEBI (Alternative Investment Funds) Regulations, 2012 ('AIF Regulations') were amended and notified on June 15, 2023 and circular dated June 21, 2023 (subsumed in Chapter 22 of Master Circular for AIFs dated May 07, 2024) was issued to provide guidance to AIFs towards a consistent and standardized approach for valuation of their investment portfolios (hereinafter referred as 'valuation framework for AIFs').

3. Subsequently, SEBI is in receipt of representations from the AIF industry highlighting issues with regard to certain aspects of the valuation framework for AIFs. These issues and proposals to address the same have been discussed in this paper.

Issues for consideration

A. Applicability of valuation norms under SEBI (Mutual Funds) Regulations, 1996 to compute valuation of investment portfolio of AIFs

A.1. The aforesaid SEBI circular on valuation framework for AIFs, *inter alia*, specifies that –

I. Valuation of securities for which valuation norms have already been prescribed under SEBI (Mutual Funds) Regulations, 1996 ('MF Regulations'), shall be carried out as per the norms prescribed under MF Regulations.

II. Valuation of securities which are not covered in the para above, shall be carried out as per valuation guidelines endorsed by any AIF industry association, which in terms of membership represents at least 33% of the number of SEBI registered AIFs. The eligible AIF industry association shall endorse appropriate valuation guidelines after taking into account recommendations of Alternative Investment Policy Advisory Committee (AIPAC) of SEBI.

A.2. The eligible AIF industry association has endorsed International Private Equity and Venture Capital Valuation Guidelines (IPEV Guidelines) in this regard.

A.3. In this regard, AIF industry has submitted the following –

I. The valuation norms under the MF Regulations cannot be applied to private instruments held by AIFs, since the Mutual Fund (MF) valuation process is a rule based framework that follows a series of processes (a waterfall of decisions on expanding comparable issuances and issuers) around pricing for investments in open-ended vehicles.

II. AIFs mostly hold private investments where one needs to delve into and present a fundamental valuation based on cash flows pertinent to the underwriting thesis, which Mutual Fund guidelines do not cover.

III. In addition, the fundamental difference between investments by a MF and AIF is their holding period strategy. A MF holds its investments primarily as "AFS" or "Available for Sale" while an AIF typically holds its investments as "HTM" or "Hold Till Maturity".

A.4. Thus, AIF industry has sought that, for securities such as unlisted securities, non-traded, thinly traded and those below investment grade, valuation norms under MF regulations should not apply and these securities should be valued as per the IPEV guidelines.

A.5. The regulatory intent of the valuation framework prescribed for AIFs is to provide a guidance to AIFs towards a consistent and standardized approach for valuation of their investment portfolios and achieve uniform and fair disclosure of value of investment portfolios to all stakeholders.

A.6. Valuation of all such type of securities in an AIF's investment portfolio for which valuation norms have already been prescribed under MF Regulations, are required to be carried out as per valuation norms under MF Regulations. This was considered essential since valuation norms for a particular security/instrument is ideally kept uniform across SEBI Regulations, irrespective of the type of intermediary/fund. The intent behind the same was largely to ensure that well-traded securities are valued as per valuation norms under MF Regulations.

A.7. However, it is seen from industry's submissions that there are fundamental differences between MFs and AIFs on holding and valuing their investment portfolios. This becomes particularly stark, considering the variances in the nature of investments, duration for holding investments, open ended vs close ended nature of funds and frequency of valuation of investments.

A.8. AIFs, typically invest at various stages of the lifecycles of the companies, i.e., seed-stage, very early stage, 'asset-light' stage, growth stage, exit stage etc. and also, often in unconventional sectors that may not have tangible assets. Hence, adopting of a valuation methodology based on Net worth or earnings per share, as required in the MF norms, may not be appropriate. In this regard, IPEV guidelines prescribe various methodologies like DCF, IRR, etc. which provide a flexibility to adopt a suitable methodology based on their assessment of the business model of the investee companies. Considering the same, it is felt that the ask of the AIF industry to the extent of exempting unlisted securities from the applicability of calculation norms under MF Regulations and opting for a methodology under IPEV guidelines, merits consideration.

Proposal 1:

The framework for AIFs to carry out valuation of their investment portfolio may be suitably revised to state that –

I. Valuation of securities, other than unlisted securities, for which valuation norms have been prescribed under SEBI (Mutual Funds) Regulations, 1996 (‘MF Regulations’), shall be carried out as per the norms prescribed under MF Regulations.

II. Valuation of unlisted securities shall be carried out as per the valuation guidelines endorsed by eligible AIF Industry Association based on the recommendations of AIPAC, i.e. presently IPEV guidelines.

B. Change in valuation methodology and approach to be considered as ‘material change’

B.1. The aforesaid SEBI circular dated June 21, 2023 on valuation framework for AIFs, *inter alia*, specifies that any change in the methodology and approach for valuation of investments of scheme of AIF, shall be construed as a material change significantly influencing the decision of the investor to continue to be invested in the scheme of the AIF. In such cases, AIFs are required to adhere to certain specified processes in terms of Chapter 2 of Master Circular for AIFs.

B.2. Accordingly, in case of material changes significantly influencing the decision of the investor to continue to be invested in the AIF, existing unit holders who do not wish to continue post the change shall be provided an exit option. The process for exit shall not apply in certain material changes, where the AIF has approval of not less than 75% of unit holders by value of their investment in the AIF.

B.3. However, since the change in the methodology and approach for valuation of investments is presently considered as material change for which such exemption based on investor consent is not applicable, AIFs are required to provide an exit option to all the dissenting investors.

B.4. In this context, SEBI has received representation/feedback from industry highlighting the following –

I. Prior to issuance of the aforementioned circular, AIFs may have been following different valuation methodologies and approach for valuation of investment. Subsequent to issuance of the aforesaid circular, they are required to align/adopt their valuation methodology to IPEV guidelines or valuation norms under MF Regulations, as the case may be. Such a change in valuation methodology is for ensuring compliance with the regulatory mandate and hence, the AIFs / investors have no discretion to decide otherwise.

II. Therefore, such a change in valuation methodology/approach should not be construed as a 'material change'. Consequently, the AIFs may not be required to follow the process of providing an exit option to dissenting investors.

III. Further, modifications to valuation methods within the scope of the IPEV guidelines should also not be automatically deemed as material changes that significantly affect investors' decision-making.

B.5. Prior to introduction of the aforesaid valuation framework for AIFs, the AIF Regulations provided flexibility to AIFs to decide the methodology and approach for valuing their securities and hence, many AIFs may be using a valuation methodology that is different from the valuation norms under MF Regulations or IPEV Guidelines.

B.6. Since it is pursuant to SEBI's regulatory mandate to comply with the IPEV Guidelines/Valuation norms under MF Regulations, as the case may be, the AIFs/investors have no discretion or option to act otherwise. Thus, such change may not be construed as a 'material change' requiring exit option for dissenting investors. However, it is noted from extant practice and representations received that the industry may need explicit clarity in this regard.

B.7. Further, in terms of the aforesaid circular, any change in the valuation method/approach within the valuation guidelines under IPEV or valuation norms under MF Regulations, as the case may be, is also considered as a material change.

B.8. In this regard, IPEV Valuation Guidelines are a broad set of valuation methodologies/approaches and provide flexibility to compute valuation based on one or more techniques specified therein. Similarly, valuation norms under MF Regulations also provide different valuation methodologies/approaches for different types of securities/instruments.

Within each of the aforesaid guidelines mentioned above, Managers of AIFs and valuers may require the aforementioned flexibility in order to use the best suited method/approach for valuing their investment portfolio, depending on various circumstances and parameters. For such change in valuation methodology, AIFs being required to provide exit to dissenting investors may be onerous on the industry and may not be prudent. Considering the same, the suggestion merits consideration.

B.9. Accordingly, the matter was deliberated in the 29th meeting of AIPAC held on January 11, 2024, wherein AIPAC, after considering the aforesaid representation of industry, recommended SEBI to make suitable changes in the valuation framework in this regard.

Proposal 2:

Taking into account recommendations of AIPAC and internal deliberation, the following is proposed –

I. Change in valuation methodology/approach to comply with Chapter 22 of Master circular for AIFs on 'Standardised approach to valuation of investment portfolio of AIFs', shall not be construed as 'Material Change'.

II. Change in methodology/approach within the valuation guidelines / valuation norms prescribed for AIFs, shall not be construed as a 'Material Change'. However, in such cases, the valuation of the investment carried out based on valuation methodologies/approaches, both old and new, shall be disclosed to the investors to ensure transparency.

C. Eligibility criteria of independent valuer:

C.1. The valuation framework for AIFs, *inter alia*, specified that the independent valuer shall fulfil one of the following criteria:

I. The independent valuer is a valuer registered with Insolvency and Bankruptcy Board of India ('IBBI') and has membership of Institute of Chartered Accountants of India ('ICAI') or Institute of Company Secretaries of India ('ICSI') or Institute of Cost Accountants of India ('ICMAI') or CFA Institute; or

II. The independent valuer is a holding company or subsidiary of a Credit Rating Agency registered with SEBI; or

III. Any other criteria as may be specified by SEBI from time to time.

C.2. Subsequently, SEBI has received feedback from industry participants with respect to eligibility criteria for independent valuer. It is noted the industry participants, *inter-alia,* suggested that all valuers (individuals and entities) registered with IBBI may be considered eligible. In this context, industry participants also sought clarity that for valuers who are set up as an entity, whether a valuer entity is required to be IBBI registered valuer entity and at the same time, whether all of its directors/partners/employees are required to have membership of ICAI / ICSI / ICMAI / CFA Institute.

C.3. In terms of IBBI (Liquidation Process) Regulations, 2016, "registered valuer" means a person registered as such in accordance with the Companies Act, 2013 and rules made thereunder. In this regard, deriving power from Section 247 of Companies Act, 2013, the eligibility criteria for registered valuers have been specified in the Companies (Registered Valuers and Valuation) Rules, 2017 ('*Valuer Rules'*).

C.4. Further, the eligibility for registration as valuer under the Valuer Rules has been separately specified for persons/individuals [Rule 3(1) of Valuer Rules] and for partnership entity / company [Rule 3(2) of Valuer Rules]. Rule 3(2) of the Valuer Rules, *inter alia*, states that no partnership entity or company shall be eligible to be a registered valuer if three or all the partners or directors, whichever is lower, of the partnership entity or company, as the case may be, are not registered valuers.

C.5. Thus, it is possible that even though a valuer firm is registered with IBBI as registered valuer entity, the valuer deputed by such firms to value investment portfolio of AIFs may not have membership of ICAI / ICSI / ICMAI / CFA institute.

C.6. It is felt appropriate that over and above the registration of a valuer firm as a registered valuer entity with IBBI, it may not be necessary for each of its director / partner / employee to separately have membership of ICAI / ICSI / ICMAI / CFA institute. However, the designated deputed person(s) of the valuer firm, who is/are deputed by the valuer entity to carry out valuation of investment portfolio of AIFs, may necessarily be member of the ICAI / ICSI / ICMAI / CFA institute.

Proposal 3:

It may be clarified that the eligibility criteria for independent valuer for a partnership entity or company shall be as follows –

I. such entity or company shall be a registered valuer entity registered with IBBI; and

II. the deputed/authorized person(s) of such registered valuer entity, who undertake(s) the valuation of investment portfolio of AIFs, shall have a membership of ICAI or ICSI or ICMAI or CFA Institute.

D. Reporting of valuation of investments of AIF to performance benchmarking agencies:

D.1. SEBI circular dated February 05, 2020 titled 'Disclosure Standards for AIFs' specifies, *inter alia*, that AIFs shall provide audited data on cash flows and valuation of their scheme-wise investments to the performance benchmarking agencies within 6 months from the end of FY.

D.2. SEBI's valuation framework for AIFs, *inter alia*, requires Manager of AIF to ensure that a specific timeframe for providing audited accounts by the investee company to the AIF is included as one of the terms in subscription agreement / investment agreement with the investee company. This has been specified so as to enable AIFs to report their valuation numbers based on audited data of investee companies as at the end of the FY, to performance benchmarking agencies within the specified timeline of six months.

D.3. It has also been stated that the manager of AIF shall ensure that valuation based on audited data of investee company is reported to performance benchmarking agencies only after the audit of books of accounts of the AIF in terms of Regulation 20(14) of AIF Regulations, within the stipulated timelines.

D.4. SEBI has received feedback from industry participants that it is difficult to comply with the aforesaid requirements for the following reasons –

I. In terms of Companies Act 2013, investee companies have a timeline till six months from the end of FY, i.e., September 30th, for completing their audit based on the data as at the end of the FY.

II. The AIF will then undertake valuation of its portfolio based on the aforesaid audited figures and also undertake its own audit of books of accounts.

III. Further, in some cases, investee companies may not provide the data to AIFs in time, for reasons such as:

- Company is under litigation with the AIF and not cooperating at all;
- Due to losses or other stress situations, investee company's operations are fully halted;
- AIF may hold a very small stake in the company and, therefore, may not be able to negotiate the information rights;
- Some of the early-stage investments are failed and written off by the AIFs.

IV. Thus, it is very difficult for an AIF to be able to report valuation based on audited data of the investee company to performance benchmarking agencies, after the audit of their books of accounts within the stipulated timeline of 6 months from the end of FY.

D.5. The above constraints highlighted by the industry with respect to timeline for reporting valuation to performance benchmarking agencies merits consideration. Accordingly, an additional one month may be provided to AIFs to submit the aforesaid valuation data to performance benchmarking agencies i.e. by October 31 of each year (instead of September 30).

Proposal 4:
AIFs shall provide audited data on cash flows and valuation of their scheme-wise investments, after the audit of books of accounts of the AIF in terms of Regulation 20(14) of AIF Regulations, to Performance Benchmarking Agencies within 7 months from March 31, i.e., by October 31 of each year.

Public comments

4. Considering the implications of the aforementioned matter on the market participants, public comments are invited for the Proposals 1 to 4 above. The comments / suggestions may be provided latest by June 13, 2024, via online web-based form through the following link:

   https://www.sebi.gov.in/sebiweb/publiccommentv2/PublicCommentAction.do?doPublicComments=yes

   (The instructions to submit comments on the consultation paper are as under:

   I. Before initiating the process, please read the instructions given on top left of the web form as "*Instructions*";
   II. Select the consultation paper you want to comment upon from the drop-down under the tab –"Consultation Paper" after entering the requisite information in the form;
   III. Email ID and mobile number cannot be used more than once for providing comments on the same consultation paper;
   IV. If you represent any organization other than the types mentioned under dropdown in "Organization Type", please select "Others" and mention the type, which suits you best. Similarly, if you do not represent any organization, you may select "Others" and mention "Not Applicable" in the text box;
   V. There will be a dropdown of proposals in the form. Please select the proposals one-by-one and for each of the proposal, please record your level of agreement with the selected proposal. Please note that submission of agreement level is mandatory;
   VI. If you do not want to react on any proposal, you may skip the same by selecting "Skip this proposal";
   VII. If you want to provide your comments for the selected proposal, please select "Yes" from the dropdown under "Do you want to comment on the proposal" and use the text boxes provided for the same;
   VIII. After recording your response to the proposal, click on "Submit" button. System will save your response to the selected proposal and prompt you to record your response for the next proposal. Please follow this procedure for all the proposals given in the dropdown;
   IX. Please download the pdf file, link of which is given at the bottom of the form, just before finally submitting the comments to last and final proposal. This pdf will help in case technical issue is faced while final submission of comments;

X. The final comments shall be submitted only after recording your response on all of the proposals in the consultation paper.)

5. In case of any technical issue in submitting your comment through web based public comments form, you may contact afdconsultation@sebi.gov.in with the subject of the email as, *"Consultation Paper on review of certain aspects of the framework for valuation of investment portfolio of AIFs".*

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