AIF|20240523|007

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

Dated: 23rd May 2024

Background

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').

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.

- Valuation of securities prescribed under SEBI (Mutual Funds) Regulations, 1996, shall be carried out as per the norms prescribed under MF Regulations.
- Valuation of securities not covered by the MF Regulations shall be carried out as per guidelines endorsed by an AIF industry association representing at least 33% of SEBI-registered AIFs, incorporating AIPAC recommendations.
- The eligible AIF industry association has endorsed the **International Private Equity and Venture Capital Valuation (IPEV) Guidelines.**
- The AIF industry argues MF valuation norms don't suit private instruments held by AIFs, as MFs use a rule-based framework for open-ended vehicles.
- AIFs typically hold private investments requiring fundamental valuations based on cash flows, not covered by MF guidelines.
- MFs generally hold investments as **"Available for Sale" (AFS),** whereas AIFs hold theirs as **"Hold Till Maturity" (HTM).**
- AIFs request that unlisted, non-traded, thinly traded, and below-investment-grade securities be exempt from MF valuation norms and valued per IPEV guidelines.
- Considering the unique nature of AIF investments, including various lifecycle stages and unconventional sectors, the flexible methodologies of IPEV (like DCF, IRR) are deemed more suitable than MF norms based on net worth or earnings per share.

Proposal A

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

- 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.
- 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.'

- The SEBI circular dated June 21, 2023, mandates that any change in the valuation methodology for AIF investments is considered a material change, requiring adherence to processes outlined in the Master Circular for AIFs.
- Existing unit holders who dissent to such changes must be given an exit option unless 75% of unit holders by value approve the change.
- The industry argues that aligning valuation methodologies to IPEV guidelines or MF regulations, as required by SEBI, shouldn't be deemed a 'material change' since it's a regulatory mandate without investor discretion.
- Therefore, AIFs should not need to provide an exit option for dissenting investors when changing valuation methodologies to comply with regulatory requirements.
- Modifications to valuation methods within the IPEV guidelines should also not be automatically considered material changes affecting investors' decisions.
- Previously, AIFs had flexibility in their valuation methods, but the new framework requires compliance with IPEV guidelines or MF norms, removing discretion.
- The industry seeks clarity, suggesting that changes mandated by SEBI shouldn't necessitate exit options for dissenting investors, as this could be burdensome.
- The Alternative Investment Policy Advisory Committee (AIPAC), in its 29th meeting on January 11, 2024, recommended that SEBI amend the valuation framework to reflect these considerations.

Proposal B

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

- 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'.
- 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:

- SEBI's valuation framework for AIFs specifies that independent valuers must either be IBBI-registered and members of ICAI, ICSI, ICMAI, or CFA Institute; or be linked to a SEBI-registered Credit Rating Agency; or meet other SEBI-specified criteria.
- Industry feedback suggested all IBBI-registered valuers should be eligible and sought clarity on whether all directors/partners/employees of valuer entities need ICAI/ICSI/ICMAI/CFA membership.
- According to the IBBI (Liquidation Process) Regulations, 2016, a "registered valuer" is defined per the Companies Act, 2013, and the Companies (Registered Valuers and Valuation) Rules, 2017.
- The Valuer Rules specify eligibility separately for individuals and entities, requiring at least three or all (whichever is lower) directors or partners of a valuer entity to be registered valuers.
- It's noted that while a valuer firm may be IBBI-registered, not all its directors/partners/employees may hold memberships of ICAI/ICSI/ICMAI/CFA.
- Therefore, it's deemed sufficient for a valuer firm to be IBBI-registered, provided that the specific individuals conducting AIF valuations are members of ICAI/ICSI/ICMAI/CFA.

Proposal C

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

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

- The SEBI circular of **February 05, 2020**, titled 'Disclosure Standards for AIFs', mandates AIFs to provide audited data on cash flows and valuation of their scheme-wise investments to performance benchmarking agencies within **6 months** from the end of the **fiscal year (FY).**
- SEBI's valuation framework for AIFs necessitates inclusion of a specific timeframe for audited accounts provision by investee companies in subscription agreements or investment agreements.
- AIFs are required to ensure that valuation based on investee company's audited data is reported to performance benchmarking agencies only after the audit of AIF's books of accounts, as per **Regulation 20(14) of AIF Regulations**, within the stipulated timelines.
- SEBI received feedback from industry participants indicating challenges in compliance due to various reasons such as investee companies' audit timeline, **operational issues, legal disputes, and information accessibility.**
- Industry feedback outlined difficulties in meeting the **6-month** reporting timeline due to investee companies' audit completion timeline, operational disruptions, and information availability issues, especially in cases of failed investments.
- Considering the constraints highlighted by the industry, SEBI proposes extending the timeline for AIFs to submit valuation data to performance benchmarking agencies by one month, from **September 30 to October 31** of each year, to alleviate compliance challenges.

Proposal D

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.**

Note - The comments / suggestions to 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

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