<u>Consultation Paper on standardised approach to valuation of investment portfolio of Alternative Investment Funds</u>

Objective

1. The objective of this consultation paper is to seek comments / views / suggestions from the public on the proposals relating to valuation of investment portfolio of Alternative Investment Funds (AIFs) under the SEBI (Alternative Investment Funds) Regulations, 2012 ("AIF Regulations").

Background

2. As regards valuation of investment portfolio of AIFs, presently, AIF Regulations focus on disclosures to investors and do not prescribe any guidelines on the principles/methodology/standards to be adopted. As such, managers of AIFs have flexibility to adopt any valuation principle/methodology/standard by disclosing the same to investors in Private Placement Memorandums (PPMs) of schemes of AIFs managed by them. Presently, the modalities relating to valuation of investment portfolio of the AIFs are not disclosed in the PPMs at the time of submission to SEBI and also not reported to SEBI subsequently.

3. In order to ascertain the valuation practices adopted by AIFs, a questionnaire was sent to 150 managers of different categories of AIFs. A brief analysis of responses received, relating to proposals in this consultation paper, is placed at **Annexure A**.

Extant regulatory framework

4. The regulatory provisions in AIF Regulations and circulars issued thereunder relating to valuation of investment portfolio of AIFs are as follows –

    4.1. Regulation 23 of AIF Regulations specifies the following with regard to valuation of investment portfolio of AIFs:

    - Regulation 23(1): The AIF shall provide to its investors, a description of its valuation procedure and of the methodology for valuing assets.

    - Regulation 23(2) - Category I and Category II AIFs shall undertake valuation of their investments, at least once in every 6 months, by an independent valuer, provided that such period may be enhanced to one year on approval of at least 75% of the investors by value of their investment in the AIF.

    - Regulation 23(3) - Category III AIFs shall ensure that calculation of the net asset value (NAV) is independent from the fund management function of the AIF and such NAV shall be disclosed to the investors at intervals not longer than a quarter for close ended Funds and at intervals not longer than a month for open ended funds.

    4.2. In terms of Regulation 27(1)(b) of AIF Regulations, the manager or sponsor is required to maintain records describing valuation policies and practices.

4.3. In terms of Clause 2(h) of Fourth Schedule of AIF Regulations prescribing Code of Conduct for manager of AIFs and key management personnel of the manager and AIFs, it is stated that they shall provide appropriate and well considered inputs, which are not misleading, as required by the valuer to carry out appropriate valuation of the portfolio.

4.4. In terms of Regulation 20(14) of AIF Regulations, the books of accounts of the AIF shall be audited annually by a qualified auditor.

4.5. As per the template PPM prescribed vide SEBI circular No. SEBI/HO/IMD/DF6/CIR/P/2020/24 dated February 05, 2020, AIFs are required to disclose the following with respect to valuation in the PPM:

- For Category I & II AIFs, under the section “Principles of Portfolio Valuation”, AIF shall disclose the details of the entity to be appointed as the valuer of the Fund/Scheme, frequency of valuation of the portfolio companies, valuation principles used by the Fund/Scheme for valuation of portfolio companies (whether the Fund/Scheme follows the IPEV Guidelines) or any other guiding principles relevant for the investors to know with respect to valuation of the Fund/Scheme. As a part of the supplementary section under this section, additional information that has not been covered hereinabove may be included, such as, deviation from the IPEV principles for valuation, specifics in relation to the valuation tracking in addition to the above, and such other information that the manager intends to cover under the same.

- For Category III AIFs, under the section “Determination of the Net Asset Value of the Units”, AIF shall disclose the principles that will be used by the manager for the determination of the net asset value of units of the Fund/Scheme and may inter alia include details of the entity to be appointed as the valuer of the Fund/Scheme, valuation policy of the Fund/Scheme w.r.t general principles of valuation, exceptions and deviations from the valuation policy, asset class wise allocation of valuation methodology, valuation committee of the Fund/Scheme (if applicable) and any other guiding principles relevant for the investors to know in relation to the valuation policy.

4.6. Para 12(iii) of the aforesaid circular dated February 05, 2020 also specifies that all schemes which have completed at least one year from the date of First Close, shall report, scheme-wise valuation to Benchmarking Agencies in a timely manner for performance benchmarking.

Issues for Consideration

5. <u>Issue1: Need for standardised approach to valuation methodology</u>

5.1. Since AIF Regulations focus on disclosures to investors regarding the valuation of investments and presently do not prescribe any guidelines, managers of AIFs have the flexibility to adopt any principle/methodology/standard for valuation of investment portfolio of the AIFs managed by them.

5.2. A standardised approach with regard to valuation principles/methodology/standard for valuing investment portfolio is one of the steps to ensure fair disclosure of value of investment portfolio to the investors. It will also ensure that the valuation principles/methodologies/standards are uniform across the AIF industry and performance of a particular AIF as well as that of the AIF industry is benchmarked based on valuation carried out on uniform principle/methodology to reflect their performance in a fair manner.

5.3. The issue was deliberated in meeting of Alternative Investment Policy Advisory Committee (AIPAC) held on October 11, 2022 and November 22, 2022. Taking into account recommendations of AIPAC, it is felt that a standard method of valuation can bring convenience to the investors and hence, standard guiding principles/methodology/standard, for valuation may be prescribed.

5.4. AIPAC noted that International Private Equity and Venture Capital Valuation Guidelines ("IPEV Guidelines") serves as a standard for valuing investment portfolio of Private Equity / Venture Capital (PE/VC) funds in various jurisdictions. Considering that IPEV Guidelines also provides flexibility in terms of different valuation techniques with respect to valuation methodology to be adopted by AIFs, AIPAC recommended that AIFs may be mandated to adopt IPEV Guidelines for carrying out valuation of their investment portfolio.

5.5. IPEV Guidelines specify that the valuer should use one or more of the following valuation techniques as of each measurement date, taking into account market participant assumptions as to how value would be determined:

A. Market Approach, based on
   i. Multiple of earnings or revenue
   ii. Industry Valuation Benchmarks
   iii. Market Prices available for instruments quoted on an active market

B. Income Approach, based on Discounted Cash Flows

C. Replacement Cost Approach, based on Net Assets valuation techniques

5.6. The latest IPEV Guidelines issued on December 14, 2022 is available at link.

5.7. Further, SEBI, after due consultative process, has prescribed specific norms for valuation of certain securities/instruments such as traded securities, money market and debt securities, non-traded equity instruments, convertible debentures, warrants, etc. in other SEBI regulations, such as those specified for Mutual Funds under Eighth Schedule of SEBI (Mutual Funds) Regulations, 1996 and SEBI Circular No. SEBI/HO/IMD/DF4/CIR/P/2019/102 dated September 24, 2019.

5.8. It is essential that principles/methodologies/standards of valuation of a particular security/instrument are uniform across SEBI regulations irrespective of the type of intermediary/fund.

Proposal:

5.9. AIFs shall be mandated to carry out valuation of their investment portfolio as per IPEV Guidelines.

5.10. The valuation norms for Mutual Funds referred at para 5.7 above shall also be specified for valuation of investment portfolio of AIFs.

6. Issue 2: Criteria for Independent Valuer

6.1. While Category I & II AIFs are required to undertake valuation of their investments by an independent valuer, no criteria have been prescribed in AIF Regulations for the independent valuer. The requirement of independent valuer has been mandated considering that Category I and II AIFs invest primarily in unlisted securities where the market price is not available.

6.2. It is felt that specifying objective criteria for an independent valuer is important, especially for valuing investment portfolio of unlisted securities, which requires specific skillset.

6.3. Presently, it is not mandated for Category III AIFs to appoint independent valuer for valuation of their investment portfolio. However, considering that, as per extant regulatory framework, Category III AIFs may also invest in unlisted securities, it is felt appropriate that for the purpose of calculation of NAV, the valuation of such unlisted securities may be undertaken by independent valuer.

Proposal:

6.4. The manager of AIF shall be required to ensure that the AIF appoints such independent valuer who satisfies all of the following conditions:

(i) is a valuer registered with Insolvency and Bankruptcy Board of India (IBBI);

(ii) has membership of a professional institute established by an Act of Parliament enacted for the purpose of regulation of a profession such as Institute of Chartered Accountants of India, Institute of Company Secretaries of India, Institute of Cost Accountants of India, etc. or a CFA charter from the CFA institute;

(iii) has at least 3 years of experience in valuation of unlisted securities; and

(iv) is not an associate of manager / sponsor / trustee of the AIF.

6.5. For the purpose of calculation of NAV, Category III AIFs shall be required to undertake valuation of their investment portfolio in unlisted securities by an independent valuer.

7. Issue 3: Reporting of valuation to performance benchmarking agencies

7.1. Presently, in terms of operating guidelines for implementation of performance benchmarking issued vide SEBI circular dated February 05, 2020, data on cash flows and valuation of scheme wise investments of AIFs based on audited data as on March 31, is to be reported by AIFs to performance benchmarking agencies within 6 months i.e. by September 30, every year. Further, valuation based on unaudited data as on September 30, is to be reported to performance benchmarking agencies within 45 days i.e. by November 15 every year.

7.2. In this regard, the following have been observed:

(i) Performance benchmarking reports of AIFs by performance benchmarking agencies for audited data as on March 31 is published around November-December and performance benchmarking report of AIFs for unaudited data as on September 30 is published around January-February. Thus, the performance benchmarking report based on March data gets outdated within 2 months.

(ii) In terms of Companies Act 2013, unlisted private limited companies are required to submit audit report within 6 months from end of financial year, i.e. by September 30, which coincides with the timeline for submitting the valuation based on audited data of investee companies to performance benchmarking agencies.

7.3. Further, to ensure that verified and consistent valuation data is submitted by AIFs to performance benchmarking agencies, managers of AIFs may be required to submit the aforesaid valuation data of investee company, after the audit of books of accounts of the AIF in terms of Regulation 20(14) of AIF Regulations.

Proposal:

7.4. Managers of AIFs shall be required to ensure that one of the terms in subscription agreement/investment agreement with the investee company, stipulates a specific timeframe for providing its audited accounts to the AIF. This would enable manager of AIF to report valuation based on audited data as on March 31, to performance benchmarking agencies within the specified timeline of 6 months.

7.5. Managers of AIFs shall be required to 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.

8. Issue 4: Responsibilities of manager of AIF with regard to valuation of their investment portfolio and related disclosures

8.1. Presently, AIF Regulations do not cast any responsibility on managers of AIFs with regard to fair valuation of investment portfolio of AIFs managed by them.

8.2. In this regard, it is noted that responsibility/obligation has been cast on asset management company of a mutual fund in the following manner:

(i) In terms of Regulation 25(19) of SEBI (Mutual Funds) Regulations, 1996 ("MF Regulations"), the asset management company shall compute and carry out valuation of investments made by its scheme(s) in accordance with the investment valuation norms specified in Eighth Schedule of MF Regulations, and shall publish the same.

(ii) Para (g) of Eight Schedule of MF Regulations states that the responsibility of true and fairness of valuation and correct NAV shall be of the asset management company, irrespective of disclosure of the approved valuation policies and procedures i.e. if the established policies and procedures of valuation do not result in fair/ appropriate valuation, the asset management company shall deviate from the established policies and procedures in order to value the assets/ securities at fair value: Provided that any deviation from the disclosed valuation policy and procedures may be allowed with appropriate reporting to Board of Trustees and the Board of the asset management company and appropriate disclosures to investors.

8.3. In the interest of the investors of AIFs, it is felt that similar responsibilities may be stipulated for managers of AIFs to bring the same in line with the aforesaid regulatory frameworks.

8.4. It is also felt that in case there is a substantial deviation between two consecutive valuations, the reasons/factors for such deviation should also be disclosed to the investors in addition to disclosure of valuation principle/methodology/standard and changes therein, if any. Such disclosures shall keep the investors abreast about reasons for substantial deviation in the value of their investments in AIFs and enhance their confidence in the AIF industry.

Proposal:

8.5. With regard to responsibilities of manager for valuation, the following is proposed:

(i) Managers of all SEBI registered AIFs shall be required to ensure that the independent valuer computes and carries out valuation of investments made by the scheme(s) of AIFs in accordance with the stipulated guidelines.

(ii) The Manager shall be required to be responsible for true and fair valuation of the investments made by the scheme of the AIF, provided that where the established policies and procedures of valuation do not result in fair and appropriate valuation, the manager may be required to deviate from the established policies and procedures in order to value the assets or securities at a fair value and document the rationale for such deviations.

(iii) Any such deviation from the disclosed valuation policy and procedures shall be allowed along with disclosure of the documented rationale to the trustee or the trustee company or the Board of Directors or designated partners of the AIF and investors of the AIF.

(iv) At each asset level, in case there is a deviation of more than 20% between two consecutive valuations or a deviation of more than 33% in a financial year, the manager shall be required to inform the investors the reasons/factors for the same, both generic and specific, including but not limited to change in accounting practices/policy and/or changes in assumptions/projections or changes in valuation principle/methodology/standard, and reasons thereof.

8.6. The manager shall be required to disclose the following to the investors of the AIF:

(i) Details of the valuation principle/methodology/standard adopted under the stipulated guidelines for each asset class of the scheme of the AIF.

(ii) Details of changes in the aforesaid principle/methodology/standard, if any, for valuation of each asset of the scheme of the AIF.

(iii) Details of changes in accounting policy / practices, if any, of the investee company and the scheme of the AIF.

(iv) Details of impact of the aforesaid changes in terms of valuation.

Public Comments

9. Public comments are invited for the proposals at para 5.9, 5.10, 6.4, 6.5, 7.4, 7.5, 8.5 and 8.6 above. The comments / suggestions may be provided as MS Excel file as per the format given below:

Name of the person/ entity proposing comments:	
Name of the organization (if applicable):	
Contact details:	
Category: whether market intermediary/ participant (mention type/ category) or public (investor, investee company, academician etc.)	

Sr. No.	Para. no. of the consultation paper	Extract from the consultation paper	Comments / Suggestions	Rationale

10. Kindly mention the subject of the communication as, “Comments on Consultation Paper on standardised approach to valuation of investment portfolio of Alternative Investment Funds”

11. Comments as per aforesaid format may be sent by email to Shri. Sachin Kisan Jadhav (sachinj@sebi.gov.in) and Ms. Padma Bharathi S (padmab@sebi.gov.in), latest by January 23, 2023.

Annexure A

1. Responses were received from the 150 managers for 246 AIFs managed by them. Category wise breakup of the same is as under:

Category of AIF	No. of managers	No. of AIFs	No. of schemes of AIFs
Category I AIF	50	66	77
Category II AIF	50	127	192
Category III AIF	50	53	105
Total	**150**	**246**	**374**

2. As regards the valuation practices of aforementioned 105 schemes of Category III AIFs, it is observed that valuation of investment in listed securities is done at the closing price quoted on the relevant exchange and valuation of unlisted securities is carried out at cost or by discounted cash flow, sales multiples method, etc. However, it is understood that only 9 out of aforesaid 105 schemes have invested in unlisted securities.

3. As regards the aforementioned 269 schemes of Category I and Category II AIFs, which invest primarily in unlisted securities, it is observed that,

    i. Various valuation principles/methodologies/standards have been adopted by these schemes for valuation of their investment portfolio and following are the details of the same:

Valuation principle/methodology/standard	No. of schemes	Percentage
IPEV Guidelines	71	26.39%
Asset class based approach	59	21.93%
Market approach	52	19.47%
Income approach	46	17.10%
Cost based approach	13	4.83%
International valuation standards	7	2.60%
Royal Institution of Chartered Surveyors (RICS) valuation standards	3	1.12%
Accrual basis approach	4	1.49%
Others	14	5.07%
Total	**269**	**100%**

    ii. Valuers with different qualifications have been appointed for valuation of these schemes and following are the details of the same:

Qualification	No. of schemes	Percentage
Chartered Accountants registered with Institute of Chartered Accountants of India	121	44.98 %
Valuation Professionals registered with Insolvency and Bankruptcy Board of India	63	23.42%
Merchant Bankers registered with SEBI	33	12.28%

Qualification	No. of schemes	Percentage
Chartered Financial Analysts registered with CFA Institute	17	6.31%
Chartered Surveyors registered with Royal Institute of Chartered Surveyors	12	4.46%
Others	23	8.55%
Total	**269**	**100%**

iii. Barring one scheme of Cat II AIF, independent valuers engaged by Cat I and Cat II AIFs are not associates of the AIF or its manager or sponsor.

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