Investment Funds: Monthly Digest

November 14, 2024

AIFS AND VALUATION: SEBI'S FRESH TAKE ON GUIDELINES

- Valuation of non-traded and thinly traded unlisted securities and listed securities to be as per IPEV Guidelines
- SEBI relaxes eligibility requirements for independent valuers
- Provides additional time period to submit data to performance benchmarking agencies
- Changes in valuation methodology no longer require exit opportunities for dissenting unit holders

The evolving landscape of Alternative Investment Funds ("**AIFs**") has prompted significant regulatory changes aimed at enhancing operational efficiency and aligning valuation practices with industry needs. Recently, the Securities and Exchange Board of India ("**SEBI**") issued a circular[1] ("**Valuation Framework Circular**") on September 19, 2024 modifying the valuation framework for AIF's investment portfolios pursuant to industry representations. SEBI has introduced critical modifications to valuation methodologies, compliance requirements, eligibility requirements for independent valuers and reporting timelines. By promoting flexibility, transparency, and improved governance, these regulatory updates streamline the operational framework for AIFs. In this edition of the monthly digest, we discuss the amendments and impact on the industry.

I. MODIFICATION IN FRAMEWORK FOR VALUATION OF INVESTMENT PORTFOLIO OF AIFS

Vide circular dated September 19, 2024, SEBI has modified the framework for valuation of investment portfolios of AIFs. According to the said Valuation Framework Circular, SEBI has amended Paragraph 22 of Master Circular for AIFs dated May 07, 2024[2] ("**AIF Master Circular**"). These amendments are pursuant to SEBI's proposals in its 'Consultation Paper on review of certain aspects of the framework for valuation of investment portfolio of AIFs' dated May 23, 2024 (as discussed in our earlier digest available here). In the said consultation paper, SEBI sought to address representations from the AIF industry highlighting issues with regard to certain aspects of the valuation framework for AIFs.

Notably, Alternative Investment Policy Advisory Committee through internal deliberations had identified four major issues with the incumbent framework :

- ***Applicability of valuation norms to compute valuation of investment portfolio of AIFs:***[3]

  AIF Master Circular provides for the valuation of securities for which valuation norms have already been prescribed under Regulations 25(19) and Regulation 47 of the Securities and Exchange Board of India (Mutual Funds) Regulations 1996 (**"Mutual Fund Regulations"**) in accordance with the norms specified in the Eighth Schedule therein. Currently, the Mutual Fund Regulations govern the valuation of traded securities, non-traded securities, thinly traded securities and illiquid securities. The Valuation Framework Circular has now carved out unlisted securities and listed securities which are non-traded and thinly traded from being subject to governance norms prescribed under Mutual Fund Regulations. Notably, this carveout was sought by the AIF industry as highlighted in May 23 Consultation Paper.[4]

  The industry participants opined that valuation norms under Mutual Fund Regulations should not apply to the stated classes of securities and should be valued as per the valuation guidelines prescribed by International Private Equity and Venture Capital Board[5] (**"IPEV Guidelines"**) (available here) owing to fundamental methodological differences between Mutual Funds and AIFs in terms of holding and valuing their investment portfolios. These methodological differences arise from variances in the nature of the underlying investments, including but not limited to the 'duration for holding investments, open ended vs close ended nature of funds and frequency of valuation of investments'. Further, AIFs often invest at critical stages of the lifecycles of the companies or in unconventional sectors that rely heavily on intangible assets that are fundamentally difficult to value. Hence, adopting of a 'one size fits all' valuation methodology premised on net worth or earnings per share, as required in the Mutual Fund Regulations, was argued to be inappropriate by industry representatives. In contrast, the IPEV Guidelines were preferred since they provide for flexibility in adopting a suitable methodology based on a holistic assessment of the business model of the investee companies.

- ***Change in valuation methodology and approach being considered as 'material change':***[6]

  The AIF Master Circular provides[7] that the valuation of securities which are not covered therein, shall be carried out as per valuation guidelines endorsed by any AIF industry association whose membership constitutes at least 33% of the number of SEBI registered AIFs. The AIF Master Circular further provides that any change in the methodology and approach for valuation of investments of scheme of AIF as necessitated by changes in the aforementioned

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valuation guidelines, shall be construed as 'material change significantly influencing the decision of the investor'.[8] It also mandates that the provision of an exit opportunity to dissenting unit holders in light of 'material changes' significantly influencing the decision of the investor.[9]

Thus, under the AIF Master Circular, it is compulsory for AIFs to provide an exit opportunity to dissenting unit holders (if any) following every change in methodology or approach to valuation. Given this construct, the AIF Industry argued that since the alignment of valuation methodology with IPEV Guidelines or valuation norms under MF Regulations are regulated under the AIF Master Circular itself, it would be unreasonable that the AIF be required to provide an exit opportunity to dissenting unit holders for the same.

The Valuation Framework Circular has now revised Paragraph 22.2.2 of the AIF Master Circular and has specified that changes in valuation methodology in compliance with Clause 22.1 of the AIF Master Circular shall not be construed as 'Material Change'. The introduction of Paragraph 22.2.3 further provides that no change in methodology/approach within the extant valuation guidelines would constitute a 'material change' altogether, provided that the said valuation methodologies, both old and new, shall be disclosed to the investors in the interest of transparency.

- ***Eligibility criteria of independent valuers to be appointed by AIFs:***[10]

SEBI has now relaxed the eligibility criteria to become an 'independent valuer' through Valuation Framework Circular. Under the AIF Master Circular, SEBI had mandated the following eligibility requirements for an independent valuer:

- Registered as a valuer with Insolvency and Bankruptcy Board of India ('IBBI') and has membership with ICAI / ICSI / ICMAI / CFA; or
- Is a holding company or subsidiary of a Credit Rating Agency registered with SEBI; or
- Any other criteria as may be specified by SEBI from time to time.

Industry participants expressed the need for the eligibility requirements for an "independent valuer" under the AIF Master Circular to align with those of a "registered valuer" as outlined in the Companies (Registered Valuers and Valuation) Rules, 2017 ("**Valuer Rules**") and Section 247 of the Companies Act, 2013. It is important to note that, according to the Valuer Rules, a partnership firm/company is ineligible to be a registered valuer if three or all of its partners or directors—whichever is lower—are not registered valuers.

This may not only lead to cumbersome situations where a firm cannot be registered simply because at least three of its partners are not registered valuers, but also to a situation where the firm itself may be registered with the IBBI as a registered valuer entity, but the individual valuers assigned to evaluate the investment portfolios of AIFs might not necessarily hold memberships with professional bodies such as ICAI, ICSI, ICMAI, or CFA Institute.

In light of this, it was proposed that while the valuation firm must be a registered valuer entity with IBBI, the threshold for partners / directors to be registered should be done away with. Instead, the it should be mandatory that the designated valuers assigned by the firm to conduct the valuation of AIF investment portfolios are members of either ICAI, ICSI, ICMAI, or CFA Institute.

To address these considerations, SEBI has streamlined the eligibility criteria for an "independent valuer." An eligible independent valuer must be a registered valuer entity with IBBI, and the designated individuals responsible for the valuation must hold membership in one of the specified professional bodies.

- ***Timeline for reporting valuation of investment portfolio by AIFs to Performance Benchmarking Agencies:***[11].

SEBI circular dated February 05, 2020 titled 'Disclosure Standards for AIFs'[12] specifies, inter alia, that AIFs are required to 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 the financial year. Under the current valuation framework, fund managers must specify a timeframe in the subscription/investment agreement with each investee company for providing audited financial statements. This requirement ensures that AIFs can report valuations based on the investee companies' audited financials as of March 31, enabling compliance with the six-month reporting deadline to performance benchmarking agencies. However, industry participants have raised concerns regarding the feasibility of this timeline. Investee companies are mandated under the Companies Act, 2013, to complete their audits by September 30, six months after the end of financial year. Consequently, AIFs have limited time to conduct valuations based on these audited figures, as well as to perform their own audits of financial records, even if the investee companies submit their audits punctually.

In response to these concerns, SEBI has amended the valuation framework to extend the deadline for AIFs to provide audited data. The new timeline allows AIFs to submit this information within seven months from the end of the financial year, with the new deadline set for October 31 of each year.

ANALYSIS

The recent updates to the AIF Master Circular by SEBI mark a crucial evolution in the regulatory landscape for AIFs reflecting an understanding of the unique challenges GPs face. By allowing AIFs to adopt valuation methodologies aligned with the IPEV Guidelines, SEBI acknowledges the inherent differences between AIFs and Mutual Funds. AIFs often invest in sectors that rely on intangible assets and engage at critical stages in a company's lifecycle, where conventional valuation methods may not apply. The flexibility to choose methodologies that better suit the nature of their investments enables AIFs to conduct more accurate valuations, ultimately leading to improved investment decision-making. Additionally, the revision of the definition of "material change" significantly reduces compliance burdens by removing the requirement for exit opportunities for dissenting unit holders when changes are in line with established guidelines. This streamlining empowers GPs to focus on strategic portfolio management without the added pressure of complex exit provisions.

Moreover, the extension of the timeline for AIFs to submit audited data to performance benchmarking agencies addresses critical industry concerns regarding the feasibility of compliance. With the new deadline set for October 31, AIFs are afforded sufficient time to conduct thorough valuations based on timely audited financials from investee

Scope of judicial interference and inquiry in an application for appointment of arbitrator under the (Indian) Arbitration and Conciliation Act, 1996
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companies, ensuring the accuracy and reliability of reported data. This change not only enhances the quality of information available to benchmarking agencies but also strengthens the credibility of AIFs in the eyes of investors. Additionally, the relaxed eligibility criteria for independent valuers broaden access to qualified professionals, which is essential for maintaining high standards in valuation practices. Overall, these regulatory changes promote a more transparent, adaptable, and efficient environment for AIFs.

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[1]SEBI/HO/AFD/PoD-1/P/CIR/2024/123.

[2]SEBI/HO/AFD-1/AFD-1-PoD/P/CIR/2024/39.

[3]Paragraph 22.1.1 of the AIF Master Circular.

[4]SEBI Consultation Paper on review of certain aspects of the framework for valuation of investment portfolio of AIFs (May 23, 2024), Paragraph A4.

[5]International Private Equity and Venture Capital Valuation Guidelines, December 2022 (available at https://www.privateequityvaluation.com/Portals/0/Documents/Guidelines/IPEV%20Valuation%20Guidelines%20-%20December%202022.pdf)

[6]Paragraph 22.2 of the AIF Master Circular

[7]Paragraph 22.1 of the AIF Master Circular.

[8]Paragraphs 2.5.4 & 2.5.5 of the AIF Master Circular.

[9]Paragraph 2.5.4 of the AIF Master Circular defines 'Material Changes' as changes in the fundamental attributes of the fund/scheme, including but not limited to changes in sponsor/manager, changes in control of sponsor/manager and changes to the fees structure corresponding to higher fees.

[10]Paragraph 22.3.4 of the AIF Master Circular.

[11]Paragraph 22.4.1 of the AIF Master Circular.

[12]SEBI/HO/IMD/DF6/CIR/P/2020/24
