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PROMOTING ALTERNATE CAPITAL ECOSYSTEM

To,

12th February 2024

Shri B Rajendran,
Executive Director,
Securities and Exchange Board of India (**SEBI**)
Plot No.C4-A, 'G' Block
Bandra-Kurla Complex, Bandra (East),
Mumbai - 400051

CC : Ms. Aparna Thyagarajan, Chief General Manager,
Shri Sanjay Singh Bhati, Deputy General Manager,

Re: **Comments related to the application of Mutual Fund guidelines referenced in Section 3.1 within the 'Standardised approach to valuation of investment portfolio of Alternative Investment Funds (AIFs)', dated June 21, 2023**

Respected Sirs and Ma'ams:

SEBI, vide its circular SEBI/HO/AFD/PoD/CIR/2023/97 dated June 21, 2023 and titled "Standardised approach to valuation of investment portfolio of Alternative Investment Funds (AIFs)" ('Valuation Circular') has stated the following under **Clause 3** in section **A. Manner of valuation of AIF's investments**:

> *3.1: 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.*
>
> *3.2 Valuation of securities which are not covered in para 3.1 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*

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industry association shall endorse appropriate valuation guidelines after taking into account recommendations of Alternative Investment Policy Advisory Committee of SEBI.

Alternative Investment Policy advisory Committee of SEBI has endorsed IPEV valuation framework for AIF portfolio and accordingly IVCA , the AIF industry association, which meets the required threshold under clause 3.2 of the above said circular has also endorsed the IPEV framework for valuation of AIF portfolio.

IPEV guidelines have been continually developed by a group of industry associations since 2005 and have been adopted by over 40 private capital industry associations for best practices in private equity and venture capital investment valuations. These guidelines have been specifically drafted keeping in perspective the characteristics of the PE/VC (AIF) product as an alternate investment avenue as compared to mutual funds (MF). The characteristics of Alternative Investment Funds (AIF) are highly varied vis-a-vis those of mutual funds as regards to risk, tenure, investment strategies, liquidity, investor profile and most importantly portfolio of securities. Thus, the valuation of AIF portfolio requires a completely different lens from that of valuation of MFs.

Please see Annexures 1 and 2 for a summary of the structural differences between MFs and AIFs, and what they hold as well as details around the MF valuation norms and how these should be considered in the context of portfolio valuations for AIFs.

<u>The primary observation is that the valuation guidelines under the latest version of the MF Rules are not applicable towards the valuation of private investments, both debt and equity held by AIFs.</u>

As explained in Annexure 2, the results following these methods may not be in accordance with fair value as defined under all international accounting standards (Ind-AS, US GAAP, IFRS). The 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 studies for investments held in open-ended vehicles. 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 MF guidelines do not cover. The fundamental valuation and the concept of calibration along the facts and circumstances are central to arriving at the accounting definition of Fair Value which Limited Partners in AIFs demand. The fundamental difference between investments by a MF and an AIF is its holding period strategy. A MF holds its investment primarily as "AFS" or Available for Sale while an AIF typically holds this as "HTM" or Hold Till Maturity.

Private capital investors do not think in terms of the flow-chart of processes in the regulations, but rather on a bottoms-up analysis based on the underwriting and what that would entitle them to receive from another investor that would 'step into their shoes' (i.e. an exit price).

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Unlisted securities – private equity

MFs cannot invest in unlisted equities and can invest only up to 10% in unlisted debt Very few of the recommended methodologies would find validation in market activity. Of note, taking a 75% haircut to comparable multiples for equity, or marking loss making companies to zero would disregards the value discovery process at a high level across the industry and its participants investing across various stages in start-ups, and is not in line with industry activity. Here again the AFS vs HTM strategy plays an important role in ascertaining a value for these securities. For MFs the need for a rule based valuation is critical given its open ended nature where NAV has to be derived every single day vs an AIF which has no such compulsions.

Unlisted securities - Private Debt

Private Debt securities in AIFs cannot be categorised or valued as fixed income securities held in mutual funds.

The capabilities, skill sets, methodologies (waterfall approach) followed by existing valuation agencies under the MF valuation norms are primarily aligned for public debt securities (investment grade). The Waterfall approach suggested by the Master Circular and AMFI including polling is applicable to marketable standardised debt instruments held by MFs, and would be restrictive or misleading if applied to private debt held by AIFs. AIF debt is highly structured and special purpose oriented. Waterfalls would lead to generalisation of different strategies and instrument features. On Polling, superimposing a ‘poll’ of inputs from other borrowers for bespoke ‘below investment grade’ private credit disregards the fact that these instruments do not trade.

The regulations are silent on the role collateral cover would play in determining the valuation. Significant attention should be given to the quality of collateral and its marketable value at the date of valuation.

Unlike mutual funds, AIFs are in a position to closely monitor the underlying investee companies and even hold 100% of the debt or a particular debt issuance. In a below investment grade security an AIF may attempt to forecast timing and quantum of recovery and arrive at the present value of investment using an appropriate discount rate.

All valuers can apply frameworks in the expanded IPEV note provided by the industry association to value private debt securities across strategies like performing credit, special situations, stressed assets, venture debt, etc.

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Recommendation :

Thus based on the rationale given above and amplified further in Annexure 1 & 2 attached herewith we propose the following

1. Valuation norms under the MF Regulations can be applied only as regards to listed and traded equity and debt securities up to investment grade. 'Valuation of publicly traded securities evidenced to be jointly held between Mutual Funds and AIFs 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. (For this purpose, the definition of traded money market, government security & debt security will be as per Clause 9.1.3.1 and definition of traded equity shares and other securities, will be as per clause 9.2.1.1 of the Master Circular dated 19th May 2023 of the MF Regulations) and
2. Valuation norms under the MF Regulations cannot be applied to private instruments held by AIFs
   Thus, for all securities such as unlisted securities, non-traded, thinly traded and those below investment grade, MF regulations should not apply, and they will be valued as per clause 3.2 of the said SEBI circular.

We request you to consider our proposal favourably and let us know if you need further clarity or information. We are also available for a discussion on the subject matter

With utmost respect,

Rajat Tandon
President
Indian Venture & Alternate Capital Association (IVCA)

CC: Rahul Shah, IVCA +91 97022 88252
CC: Rohan Parulekar, IVCA +91 98190 01130

Enclosed: Annexure 1 & 2

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Annexure 1

Structural difference in Mutual Funds and Alternative Investment Funds:

Feature	Mutual Fund	Alternative Investment Funds
Types of Schemes	A mutual fund is a pool of money managed by a professional fund manager, and it collects money from a number of investors who share a common investment objective. The fund then invests in equities, bonds, government securities, gold, and other assets, and the income/gains generated from this collective investment is distributed to the investors.	SEBI defines Alternative Investment Funds (AIFs) as privately-pooled investment funds, whether from Indian or foreign sources, established or incorporated in India in the form of a trust, company, or body corporate. These funds collect funds from sophisticated investors for investing in accordance with a defined investment policy. AIFs are categorized into three main (I, II and III) categories based on their investment objectives, risk profiles, and regulatory requirements, which are defined by SEBI. Each category has its own specific investment conditions and is tailored to suit the needs of different types of investors, such as high-net-worth individuals, family offices, and institutional investors.
Entry and exit of investors	Largely, Mutual Funds ('MF's) are open-ended funds which allow entry and exit of investors on a daily basis. Open-end mutual funds are investment vehicles that use pooled assets from investors to create a diversified portfolio. These funds can issue an unlimited number of new shares and redeem them as well, based on investor demand. These funds are highly liquid The shares of open-end mutual funds are priced daily based on their current net asset value (NAV), which is calculated by dividing the total value of the fund's assets by the number of outstanding shares When an investor buys shares of an open-end fund, the fund creates new shares, and when an investor sells shares, the fund takes them out of circulation. Open-end mutual funds do not trade on exchanges, and their shares are bought and sold on demand at their net asset value ('NAV').	Both: - Category I AIFs (invest in start-ups, early-stage ventures, SMEs, social ventures, infrastructure, or other sectors considered socially or economically desirable by the government) and - Category II (includes private equity funds, debt funds, and funds of funds) AIFs are required to be close-ended and have a minimum tenure of three years. CAT I & CAT II funds are highly illiquid. Category III AIFs, also encompass hedge funds (investment vehicles that employ diverse or complex trading strategies and may use leverage, including through investments in listed or unlisted derivatives) may be open-ended or close-ended. Closed-ended AIFs are those that do not provide redemption facilities to investors, while open-ended AIFs do provide such rights.

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Public v/s private	Public market. Mutual funds are not allowed to invest in unlisted securities directly. Instead, they can invest in unlisted securities through private placements, Employee Stock Ownership Plans (ESOPs), delistings, etc. Post the IL&FS crisis of 2018, the regulator prohibited MFs from investing in unlisted debt instruments, including commercial papers, with the exception of government securities and other money-market instruments.	Private equity and debt.
Listing status of underlying's	Predominantly listed. MFs cannot invest in unlisted equities and can invest only upto 10% in unlisted debt Reference: MF: Para 1A & 11 of the Seventh Schedule of MF Regulations	Predominantly unlisted. Reference: AIF: SEBI AIF Regulation – Regulation 17 (a).
Fair Value concept	Fair values for the net asset value of the MFs are important to ensure existing, incoming or exiting investors don't benefit or lose out at the cost of others. and MF units are traded only at NAV (net of exit load, if any)	Fair value is important to provide existing investors with information on the underlying portfolio such that they can make their asset allocation decisions amongst private fund managers. Further secondary trades in AIF units are very rare and even if they take place the price per unit between the parties are negotiated and do not necessarily take place at the NAV of the Fund
Debt Portfolios	Can't invest below non-investment grade. Reference: SEBI MF Regulation 44 (1), and Seventh Schedule, clause 1.	Private investments in the debt space are often neither rated nor investment grade, the debt securities below investment grade may form a large part of an AIF portfolio
Investor base	Widely-held, retail investor base with no minimum threshold	Privately-held; few limited partners. Sophisticated institutional and High net worth investors with minimum threshold of Rs 1 crore
Deal Structure	Standardised; marketable	Customised on deal-by-deal basis. Largely one-to-one deal; or syndicated in a few situations
Credit evaluation framework	Primarily based on Probability of Default *(as reflected by external credit rating).*	Probability of Default and Loss Given Default are not standardised. A recoverability analysis during underwriting and redemption relies on the strength of collateral/security and expected events as part of the investment thesis.

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Annexure 2

Valuation norms under the MF norms:

Chapter 9 of the Master Circular for Mutual Funds as on March 31, 2023 deals with the topic of Valuation.

Mutual fund valuation norms are guidelines and regulations setup by AMFI and SEBI, respectively, that govern the process of valuing investments held by mutual funds.

These norms ensure that the valuation of securities and other assets is conducted fairly and accurately.

The chapter defines the universe of instruments and corresponding mutual fund valuation norms as follows:

Security type	Key aspects of SEBI MF Master circular	Comments
Section 9.1	**Section 9.2**	
a. traded equity;	Traded securities are valued at the last quoted closing price on the stock exchange in the case of equity and equity-related instruments. If a security other than government security, money market and debt security is not traded on a stock exchange on a valuation date, the value at which it was traded on the selected Stock Exchange, as the case may be, on the earliest previous day may be used provided such date is not more than thirty days prior to valuation date.	Only relevant if these instruments are held by AIFs. The use of the close price is in accordance with generally accepted valuation norms and IPEV.
b. non-traded (not traded for 30 days) and thinly-traded (less than INR 5L or 50,000 shares traded in a month)	If there is no current market quotation for a security or the market quotation is unreliable, the fund's board of directors or trustees has a statutory duty to "fair value" the security in good faith. The valuation norms prescribed are based on averaging the value of the net worth per share (details provided in the circular), and the capital earnings value per share (also in the circular), and taking a 15% discount for illiquidity.	These valuation norms are not applicable for private equity or private equity-related products. The rules provided under each of the processes (namely, the net worth approach, and the capital earnings method), along with the rules for companies with negative EPS or negative EPS or where balance sheets are not available for 9 months post close are not considered by buyers or sellers for venture capital and growth equity investments. At the mature end of the industry, buyouts are valued based on expected cash flows, not on the balance sheet (net worth), or steady-stage earnings capitalization with a 75% haircut from publicly traded companies in the same industry. As such none of these rules are applicable for the valuation of private equity investments.

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equity or equity-related securities;		Note, an independent valuer is required to value individual securities that exceed 5% of the AUM of a scheme. Also based on recent changes , the independent valuer is also required to be IBBI registered which lends credence to the valuation exercise.
c. non-traded (not traded on that day) money-market and debt securities;	Money market securities and debt-securities with residual maturity of up to 30 days are to be valued based on an amortization method, and if it is +/- 0.025% of a reference price provided by valuation agencies provided by AMFI. Money market securities and debt-securities with residual maturity of over 30 days are to be valued at the average of security level prices obtained from valuation agencies, or if not available, then at the purchase yield at the date of allotment. The methodology followed by valuation agencies, as mandated by AMFI, follows a waterfall approach in the case of rated, traded instruments, or a polling method in the event the security is below investment-grade.	Money-market securities are typically not held by AIFs. To the extent these are held for an interim period, the MF guidelines can apply to these instruments only. The waterfall approach and polling method for money market securities and debt-securities with residual maturity of over 30 days are not consistent with domestic and international accounting standards and IPEV in what needs to be applied for the universe of debt securities in the AIF space. These methodologies are constructed for traded instruments held by MFs that have been reclassified as non-traded for the reasons provided. Private credit investments in AIFs also do not trade by definition, however that is not a reclassification, nor are they widely held. They are mainly bilateral deals or in some cases, syndicated deals where the investors take decisions as one unit. AIF debt instruments are not traded or thinly traded, and are extremely bespoke. They are not structured similarly within their universe, unlike the publicly traded space, which compares yields and trades. While it is important to observe trends in the growing public credit market space, the correlation of the movements for other issuers of non-comparable securities is not appropriate given that these are not correlated, especially in the short-term. The spreads for many private debt issuances is well above that of the risk-free rate and almost entirely reflects a premium for the credit risk and illiquidity borne by the issuer that is larger than the base-rate. An attempt to aggregate such private issuance data for creation of an index would be inadequate, nor comparable, and violate confidential information regarding private investments between funds and their investor to recipients not privy to such information. Polling is thus not feasible nor a true measure of value. To highlight the difference, on the debt side, AIFs invest in private debt instruments and structure cashflows as per the requirements of underlying companies. Therefore, expected IRR at the time of investment is generally a good starting point to develop a framework to value the investment, especially when there are no major changes in other factors. A valuer will derive the IRR basis the consideration paid and contractual or expected cash flows, and back into spreads above the risk-free rate that can be bifurcated into relative risk factors in

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		percentage terms. For examples the relative creditworthiness of the borrower, the risk related to availability of collateral cover, the probability of recovery, etc.
d. traded money market/ debt securities; and	Traded securities are valued at the weighted-average traded (clean) prices for debt and money-market instruments.	Traded debt securities are typically not held by AIFs. To the extent these are held, the MF guidelines can apply to these instruments only..
e. below investment grade (below BBB-, or short rating below A3) and default money-market and debt securities	Below-investment grade money market and debt securities are to be valued by valuation agencies, as per AMFI. Till such time the valuation agencies compute the valuation, such securities shall be valued on the basis of indicative haircuts provided by these agencies to correspond to the date of a credit event, and to be reviewed and refreshed in the interim till new information is available. Traded prices (of minimum size lots) below the haircut value are to be considered , including applicability on accrued interest. Deviations and rationale for such are to be documented and communicated. No further details are provided on approaches on valuing below-investment grade money market and debt securities. .	Returns in the AIF space reflect those companies that are not yet suitable for raising loans from banks or the public debt markets. These are private companies for the most part, with a special bespoke requirement. Regardless of any rating applied to the security, the lender would have tied up collateral and cash flow covers that balance the risk-reward ratio within a target range for their investors. To categorise these highly tailored situations into below-investment grade and compare with instruments in the public space (traded/ non-traded) is not an appropriate starting point. The private credit investments entered into by AIFs, regardless of rating, are realised through underlying cash flows and realizable events in the near term for repayments and refinancings. These are monitored by funds and their valuers in arriving at fair values for such instruments, and incremental information is factored in post allotments/ underwriting to mark-to-market such instruments and borrower facts and circumstances. Haircuts may be appropriate for MF below investment grade instruments as they have investors that enter and exit on a daily basis. This is not the product nor permissible under a closed-ended fund such as an AIF. An AIF is responsible for periodic valuations and reporting, and will capture all the latest information available till that date. This is in accordance with all accounting standards, and IPEV. Haircuts that do not pertain to this activity cannot be reasonably defended. Finally, the MF guidelines summarized do not offer any level of detail or rigour on valuing investments that are below investment grade.
	Section 9.3	
f. securities with Put/Call Options	Securities with call options are to be valued at the lower value holding to final maturity or the call option. Securities with put options are to be valued at the higher value holding to final maturity or the put option.	Again, these are developed for the MF industry where daily redemptions and investments are possible, and are not relevant to AIFs which are close-ended vehicles and value instruments and securities specific to the terms of underwriting. Erring on conservatism to purposely understate the value for a close-ended vehicle defeats the purpose of a fair value estimate.

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		These rules are also restrictive in the realm of embedded options in private debt instruments. A variety of primary valuation methodologies as listed in IPEV are used to this effect.
	Section 9.4	
g. Perpetual bonds	Maturity of all perpetual bonds are treated as 100 years.	These instruments are typically not held by AIFs. . To the extent these are listed and if held by Aifs, the MF guidelines can apply to these instrument
	Section 9.5	
h. Government securities	Valued based on levels provided by valuation agencies.	These instruments are typically not held by AIFs. If capital called is parked in these assets, these rules would apply.
	Section 9.6	
i. Other money-market, debt securities, short-term deposits and OTC derivatives.	These are to be valued specific to guidelines already in place for money market instruments, cost plus accrual and from valuation agencies, respectively.	These instruments are typically not held by AIFs. If capital called or post exit, funds parked in these assets, these rules would apply.
	Section 9.7	
j. illiquid securities	Aggregate value of illiquid securities (defined as non-traded, thinly-traded and unlisted equity shares) shall not exceed 15 percent of the total assets of a scheme.	No additional valuation norms are provided in this clause.
	Section 9.8	
k. unlisted equity	The valuation norms prescribed are based on averaging the value of the net worth per share (details provided in the circular), and the capital earnings value per share (also in the circular), and taking a 15% discount for illiquidity.	These valuation norms are not applicable for private equity or private equity-related products. The rules provided under each of the processes (namely, the net worth approach, and the capital earnings method), along with the rules for companies with negative EPS or negative EPS or where balance sheets are not available for 9 months post close are not considered by buyers or sellers for venture capital and growth equity investments. At the mature end of the industry, buyouts are valued based on expected cash flows, not on the balance sheet (net worth), or steady-stage earnings capitalization with a 75% haircut from publicly traded companies in the same industry. As such none of these rules are applicable for the valuation of private equity investments. Note, an independent valuer is required to value individual securities that exceed 5% of the AUM of a scheme.

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	Section 9.9	
l. securities not covered by the valuation policy	These should not exceed 5% of the AUM and should be reported to AMFI immediately. Provisions should be made till the time the valuation processes are covered. Guidance of 6 weeks was provided.	AIFs invest in a different universe of securities (CCDs, CCPS, OCRPS, etc.) that are not part of the mutual fund world and approaches to these would be covered in their respective valuation policies.
	Section 9.10	
m. use of own trades	Section 9.10 disallows using own trades for valuation given past mis-use on small batches.	Calibration to past trades requires significant judgment on what constitutes an arms-length transaction and fair value. Bucketing trades as a whole as non-indicative ignores the facts and circumstances in case a bilateral debt instrument is syndicated or partly-exited and the motivations behind it.

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