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Dissolution Period for AIFs: Lifeline for Funds with an End-of-Life Crisis

INTRODUCTION

In a bid to address the hurdles presented by the 'liquidation scheme' construct for unliquidated investments held by alternative investment funds (AIFs), the Securities and Exchange Board of India (SEBI), on 25 April 2024, notified certain significant amendments to the SEBI (Alternative Investment Funds) Regulations, 2012 (AIF Regulations) by way of the SEBI (Alternative Investment Funds) (Second Amendment) Regulations, 2024 (AIF Amendment 2024)[1]. The AIF Amendment 2024 did away with liquidation schemes and introduced a framework for '*Dissolution Period*', the conditionalities of which were subsequently detailed in the circular issued by SEBI on 26 April 2024, thereby superseding the 'liquidation scheme' framework (Dissolution Period Circular)[2].

BACKGROUND

After implementation of the AIF Regulations in 2012, several initial AIFs registered with the SEBI reached the end of their life term by 2020 and thereafter, hit a roadblock with respect to unliquidated investments, due to various reasons, such as pending litigations, economic uncertainty following Covid-19 and sectoral changes. Taking note of this issue which mushroomed with numerous AIFs, SEBI, on 21 June 2023, issued a circular on '*Modalities of launching Liquidation Scheme and for distributing the investments of Alternative Investment Funds in-specie*' (Liquidation Scheme Circular)[3]. This provided an 'out' to AIFs with expired term but unliquidated investments.

The Liquidation Scheme Circular provided for the following:

(a) An option for AIFs, with an expired term, to launch a closed-ended liquidation scheme with the sole purpose of liquidation of the AIF's remaining investments (Liquidation Scheme) within 1 year following such expiry (Liquidation Period), aimed at liquidating the remaining investments.

(b) To ensure that such Liquidation Scheme did not fall back into the same blackhole of extensions of the term, the tenure was to be determined at the time of filing the placement memorandum (PPM), with no possibility of extension.

(c) A pre-requisite to the launch of such Liquidation Scheme, is the approval of at least 75% of investors of the original AIF, in terms of their investment value in the AIF.

(d) In case the AIF fails to obtain necessary investor consent for the launch of a Liquidation Scheme or for in-specie distribution of unliquidated investments (which required the same threshold of investor consent), such investments were to be compulsorily distributed in-specie to the investors, bypassing the consent requirement.

The regime of the predecessor of AIFs, i.e., venture capital funds (VCFs), was comparatively more onerous, with the requirement to liquidate investments within 3 months from the expiry of the tenure, as opposed to 1 year Liquidation Period granted to AIFs, and without any relaxation to launch a Liquidation Scheme.

Please refer to our previous Ergo[4] for our detailed views on the Liquidation Scheme Circular.

NEED FOR AMENDMENT

Although rolling over of investments from an existing scheme to another scheme, is a globally accepted framework, and may be seen as a relief for schemes facing liquidation challenges, several practical complications

[1] https://www.sebi.gov.in/legal/regulations/apr-2024/securities-and-exchange-board-of-india-alternative-investment-funds-second-amendment-regulations-2024_83060.html

[2] https://www.sebi.gov.in/legal/circulars/apr-2024/flexibility-to-alternative-investment-funds-aifs-and-their-investors-to-deal-with-unliquidated-investments-of-their-schemes_83065.html

[3] https://www.sebi.gov.in/legal/circulars/jun-2023/modalities-for-launching-liquidation-scheme-and-for-distributing-the-investments-of-alternative-investment-funds-aifs-in-specie_72922.html

[4] **https://www.khaitanco.com/sites/default/files/2023-07/Introduction%20to%20the%20concept%20of%20Liquidation%20Scheme.pdf**

were observed by AIFs around the Liquidation Scheme framework including: (i) launching a new scheme to carry over the unliquidated portfolio, leading to additional time, cost, and efforts; and (ii) tax concerns on account of transfer of assets from original scheme to the Liquidation Scheme, at the hands of investors on account of replacement of units of the original scheme with units of the Liquidation Scheme.

In response to these industry concerns, SEBI, on 12 January 2024, issued a consultation paper[5] proposing the introduction of a '*dissolution period*' — a mechanism to deal with unliquidated investments of a scheme of an AIF upon the completion of the tenure (including any extensions) —without necessitating the launch of a Liquidation Scheme for this purpose (Consultation Paper). Further, in light of a number of subsisting VCFs, the Consultation Paper also proposed to provide such VCFs the option to migrate to an AIF structure under the AIF Regulations, with the objective of extending the provisions pertaining to liquidation, including have a period of 1 year as the Liquidation Period, and the flexibility of dealing with unliquidated investments by opting for Dissolution Period to VCFs as well.

Following the Consultation Paper, the Dissolution Circular read with the AIF Amendment 2024 was notified, which provides that during the Liquidation Period, an AIF can distribute investments of a scheme which are unsold due to lack of liquidity, in-specie to the investors, or enter into dissolution period (as opposed to selling or transferring the unliquidated investment to a Liquidation Scheme), after obtaining approval of at least 75% of the investors by value of their investment in the AIF scheme (Super Majority of the Investors). The AIF Amendment 2024 also restricts the launching of any fresh Liquidation Scheme, with any existing Liquidation Scheme being governed by Liquidation Scheme Circular till such schemes are wound up.

The proposal to permit VCFs to migrate to the AIF regime to avail the flexibilities under the AIF Regulations with respect to extension of tenure, Liquidation Period and Dissolution Period, as under the Consultation Paper, has also been approved by the SEBI in its board meeting held on 30 April 2024. As per the press release, following the SEBI board meeting, a separate sub-category of Category I AIFs will be created, called 'Migrated VCFs'. Under this, the erstwhile VCFs registered under the SEBI (Venture Capital Funds) Regulations 1996 (VCF Regulations) may opt for registering themselves as Migrated VCFs, without payment of any fee and without being subject to any additional investment conditions that were not applicable to them under the VCF Regulations. However, this is not meant to be an indefinite offer, and the VCFs wanting to migrate to the AIF regime are required to do so within 12 months from the date of amendment to the AIF Regulations permitting such migration. However, the amendment permitting such migration is yet to be notified.

Following the Dissolution Period Circular, AIFs now have the option, during the Liquidation Period, to distribute unliquidated assets to investors in-kind, or to enter a Dissolution Period. However, the requirement of approval from Super Majority of the Investors continues to apply.

SEBI has prescribed the following conditions for treatment of unliquidated assets:

(a) Before seeking investor's consent, the manager of the AIF is required to arrange a bid for a minimum 25% of the value of its unliquidated assets, to provide an exit option to the dissenting investors as an alternative;

(b) The manager of the AIF will be required to make disclosures to the investors as specified by the SEBI in the Dissolution Period Circular;

(c) Prior to expiry of the Liquidation Period, the manager of the AIF is required to intimate the SEBI about obtaining investor consent and the decision to enter into Dissolution Period;

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[5] https://www.sebi.gov.in/reports-and-statistics/reports/jan-2024/consultation-paper-on-providing-flexibility-to-alternative-investment-funds-aifs-venture-capital-funds-vcfs-and-their-investors-to-deal-with-unliquidated-investments-of-their-schemes-beyond-expir-_80612.html

(d) If the manager of the AIF can arrange bids for at least 25% of the value of unliquidated investments in the scheme, dissenting investors will have the option to fully exit the scheme using the 25% bid arranged by the AIF. After the dissenting investors exercise this exit option, any remaining unsubscribed portion of the bid may be used to provide pro-rata exit to non-dissenting investors, if they choose to do so;

(e) If the manager of the AIF is unable to arrange a bid for a minimum of 25% of the value of unliquidated investments of the scheme, the AIF can still opt for the Dissolution Period, if consent of at least Super Majority of the Investors is obtained;

(f) In the event the bidder or any of its related party are investors in the scheme, such investors shall not be permitted to exit the scheme through the bid;

(g) The Dissolution Period of an AIF scheme must not exceed the original tenure of the AIF scheme and will not be subject to extensions;

(h) During the Dissolution Period, the AIF schemes are prohibited from: (a) accepting any fresh commitments from investors; (b) initiating any new investments; and (c) charging management fees; and

(i) Granting an additional Liquidation Period to those schemes which have expired or are expiring within three months from the date of notification of the AIF Amendment 2024.

ANALYSIS

1. Structured Management of Unliquidated Investments:

The Dissolution Period Circular establishes a systematic framework for AIFs to address unliquidated investments during the Liquidation Period. It lists out specific conditions, such as arranging a bid for at least 25% of the value of unliquidated investments and disclosing the bid particulars to its investors, thereby providing dissenting investors with an option to exit.

2. AIFs cannot launch Liquidation Schemes:

A significant step is the decision to halt the launch of any new Liquidation Schemes by AIFs. This measure aims to streamline the winding-up process for AIFs, thereby reducing the time, effort and costs associated with introducing additional schemes. Additionally, allowing ongoing Liquidation Schemes to continue its operations as per the Liquidation Scheme Circular until their completion, will reduce complexities such as subsequent winding-up of the Liquidation Scheme, treatment of assets rolled into a Liquidation Scheme and redemption of units issued to investors in a Liquidation Scheme.

3. One-time flexibility to extend Liquidation Period to AIFs whose Liquidation Period has expired:

To provide a one-time flexibility to certain AIFs, the SEBI has permitted an extension of the Liquidation Period until 24 April 2025 to AIFs whose Liquidation Period has already expired or is set to expire by 24 July 2024, provided that no pending investor complaints regarding non-receipt of funds / securities exist as of 25 April 2024. Conversely, for AIF schemes with pending investor complaints as of 25 April 2024, the additional liquidation period can be availed following the resolution of the complaint(s), starting from the date of resolution until 24 April 2025.

CONCLUSION

At this stage, the Dissolution Period framework is a welcome development over the Liquidation Scheme. The conditions and procedures to commence a Dissolution Period are outlined in detail above. The SEBI has duly taken cognisance of the roadblocks in dealing with unliquidated investments and has come up with a solution which addresses the issues posed by the erstwhile construct. However, practical challenges, if any, in implementing the Dissolution Period may crystallise upon its implementation at ground level. One such challenge may be the mitigation of conflicts and alignment of interests of the fund manager and investors. Although the SEBI has implemented various measures, such as requiring managers to make disclosures and obtain proper consent at various stages, there is still a significant possibility that conflicts may go unnoticed.

Further, the predecessor of AIFs have also not been forgotten in the scheme of things. The SEBI has duly approved the migration of VCFs to the AIF regime, providing relief to VCFs which were running out of options to liquidate investments in an orderly manner.

Additionally, the SEBI has taken kindly towards those schemes where the Liquidation Period for an AIF scheme has already expired or is set to expire by 24 July 2024 by giving them an extension. It appears to be a fair deal and should lift the burden that has saddled the AIF industry for some time now.

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