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SEBI ALLOWS AIFS TO LAUNCH 'LIQUIDATION SCHEME': A LIMITED PURPOSE INVESTMENT MANAGER LED 'CONTINUATION FUND'

20 July 2022

In furtherance its board meeting conducted on 29 March 2023, the Securities and Exchange Board of India (**SEBI**) notified the SEBI (Alternative Investment Funds) (Second Amendment) Regulations, 2023 on 15 June 2023 (**Amendment Regulations**) introducing the concept of liquidation scheme (**Liquidation Scheme**). The amendment was followed by the Circular No. SEBI/HO/AFD/PoD-I/P/CIR/2023/098 dated 21 June 2023 laying down the procedural framework for launching a Liquidation Scheme and for distributing the in-specie investments of AIFs (**SEBI Circular**).

Liquidation Scheme offers a practical solution to Alternate Investment Funds (**AIFs**), which are unable to liquidate their investments and wind up the fund within the stated fund life due to factors beyond their control.

In this ERGO we have set out our analysis of the Amendment Regulations. We are also pleased to invite you to our webinar on the topic where we will be discussing the regulatory framework governing Liquidation Schemes and the practical nuances in launching and operating Liquidation Schemes.

Please register here for a webinar on the topic "*Discussion on the nuances of liquidation schemes for alternative investment funds*", hosted by Khaitan and Co. on Jul 27, 2023 5:00 PM IST.

Background

The Failure of AIFs and Venture Capital Funds (**VCFs**) to wrap up their operations, liquidate investments and wind-up within the timeframe set forth in the placement memorandum has been a cause of concern for SEBI in the recent times.

SEBI recently passed two significant orders viz. order in the case of Urban Infrastructure Venture Capital Fund dated 31 October 2022 (accessed here) and the Vistra Religare Media Fund order dated 24 April 2023 (accessed here). SEBI has emphasised in these orders that VCFs have a defined lifespan and must be wound up upon the expiration of their tenure. SEBI highlighted that the investment manager does not possess the authority to extend the fund's tenure by bypassing the provisions of the Securities and Exchange Board of India (Alternative Investment Funds) Regulations, 2012 (**AIF Regulations**). Similarly, SEBI itself lacks the jurisdiction to permit extensions of tenure by easing the stipulations of the AIF Regulations.

Practical Challenges

While the fund documents outline a specific tenure of the fund and a discretionary extension period, these are established based on the average life cycle of an investment in the proposed investment sector or strategy of the fund. There are, however, unforeseen factors that might become central obstacles in the fund's liquidation process, such as:

1.	<u>Litigation Challenges</u>: A primary concern emerges when the assets held by AIFs and VCFs become ensnared in legal disputes. The process of winding up can become delayed in these situations, as the duration of legal proceedings often surpasses the tenure of these funds. If funds are compelled to liquidate adhering to SEBI's regulations, they might have to sell their assets under unfavourable conditions or at a decreased value, adversely affecting investor returns. Investee companies or promoters, aware of the fund's limited timeframe, may deliberately prolong negotiations or delay necessary actions that would otherwise protect the interests of investors. They may take advantage of the pressure on the fund manager to exit investments within the designated tenure, knowing that any delays or complications could erode the overall value of the fund. By leveraging the uncertainty and time constraints, investee companies and promoters may attempt to negotiate more favourable terms, delay necessary settlements, or even intentionally create disputes that result in protracted litigation. Additionally, there are circumstances, such as when the investee company is undergoing insolvency proceedings, where the transfer of investments requires the pre-approval of a tribunal-appointed resolution professional or the lenders of the investee company. This approval is often not readily granted, as shareholders are generally considered to be 'disenfranchised' from their rights over the investee company during the duration of the insolvency proceedings.
2.	<u>Adverse Market Situations</u>: Market conditions can create obstacles in the orderly winding up of AIFs and VCFs. If the assets cannot be sold at their market value due to an economic downturn or other unforeseen circumstances, this may lead to diminished investor returns. A forced winding up could deprive funds of the chance to recuperate and optimize returns over time.
3.	<u>Investor Safety and Equity</u>: Regulatory bodies like SEBI primarily aim to protect investor interests. However, the obligatory winding up requirement could potentially harm investors if it leads to inferior liquidation of assets. Achieving equilibrium between investor interests and regulatory compliance is vital to ensure equitable treatment and protection of all involved parties. In global practices, these situations are often handled by investment managers or Limited Partners (LPs) who choose to transfer the unliquidated assets to a distinct fund, dedicated to holding these unliquidated investments. This new fund may have the same set of investors as the original fund, only if those original investors are interested in participating in this separate fund, or it may have a different set of investors. This specially created fund is often referred to as a 'continuation fund' or a 'secondaries' fund.

SEBI'S Consultation Paper

In response to these investor concerns and the demand for holding unliquidated investments through a 'continuation fund', SEBI released a consultation paper on 3 February 2023, titled "*Consultation Paper on providing option to Alternative Investment Funds and their investors to carry forward unliquidated investments of a scheme upon completion of its tenure*" (**Consultation Paper**). The paper proposed the transfer of the unliquidated investments to a new scheme, allowing the investment manager to hold the unliquidated assets in a special purpose scheme, post the expiry of the original scheme.

The new scheme would present a solution to safeguard investor interests, particularly when assets are embroiled in litigation or cannot be sold at market value within the stipulated period.

Introduction of Liquidation Schemes

Based on the consultations with various stakeholders, SEBI, by way of the Amendment Regulations and the SEBI Circular, has operationalised the framework for launch of Liquidation Schemes.

The salient features of the Amendment Regulations and the SEBI Circular are summarised hereunder:

<table>
<tr><td>A)</td><td>What is the Liquidation Scheme?

The Liquidation Scheme operates as a closed-ended scheme, initiated solely by an AIF for the purpose of liquidating unliquidated investments acquired from its scheme after its tenure has ended. The AIF Regulations stipulate a 'liquidation period' of one year following the tenure's expiration to wind up the AIF (Liquidation Period). The Liquidation Scheme should be launched within this prescribed Liquidation Period.

To launch a Liquidation Scheme, a placement memorandum must be filed with SEBI via a merchant banker, accompanied by the payment of required fees. Additionally, the phrase 'Liquidation Scheme' must be included in the scheme's name.

<u>Comment</u>: The option of the Liquidation Scheme is only applicable to AIFs within their Liquidation Period. It does not extend to AIFs that are beyond their Liquidation Period or to VCFs. As such, these VCFs and AIFs would be required to wind up mandatorily in compliance with the AIF Regulations and VCF Regulations.

The introduction of a Liquidation Scheme also implies additional setup costs. Investors might consider these extra expenses when deciding whether to maintain their investment in the AIF.</td></tr>
<tr><td>B)</td><td>What are the key features of the Liquidation Scheme?

To ensure a timely liquidation process by the Liquidation Scheme, SEBI has determined that its tenure will be set at the time of the placement memorandum filing and will not be subject to further extension. Moreover, the Liquidation Scheme's tenure must not surpass the original tenure (excluding extensions) of the AIF. As the Liquidation Scheme is exempt from acquiring SEBI's comments on the placement memorandum, its tenure is calculated from the placement memorandum's filing date with SEBI.

Additionally, the Liquidation Scheme is prohibited from accepting new commitments from any investor or making new investments. If the assets of the Liquidation Scheme are not sold due to a lack of liquidity at the tenure's end, they will be managed as directed by SEBI.

<u>Comment</u>: The intention of SEBI is to limit the lifespan of the Liquidation Scheme and have it operate strictly for liquidating the AIF's unliquidated investments. It's crucial to consider the impact of a Liquidation Scheme's creation on the AIF's legal proceedings. To ensure the AIF investors can effectively present their cases in existing litigations, it's essential that courts perceive the Liquidation Scheme as an</td></tr>
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	extension of the AIF, thus preserving investors' rights and liabilities. The prohibition on extending the Liquidation Scheme's tenure might pose a risk for investors bidding on the unliquidated investments of an AIF with assets involved in litigation. Even if the litigation isn't resolved within the Liquidation Scheme's tenure, they are still required to wind up the scheme within the stipulated timeframe. This could impact the value of their unliquidated investments at the tenure's end. Therefore, SEBI should have maintained the discretion to permit extensions of Liquidation Scheme tenures when a compelling case for extension is presented. As the Liquidation Scheme is an extension of the existing scheme, it is hoped that the transfer of unliquidated assets to the Liquidation Scheme is viewed as a tax-neutral migration, thereby not triggering any tax for the relevant stakeholders (including but not limited to the AIF, Liquidation Scheme and the investors).
C)	**What is the process of launching a Liquidation Scheme?** <u>Step 1</u>: The launch of a Liquidation Scheme requires the approval of at least 75% of investors, in terms of their investment value in the AIF. The investment manager must disclose the methodology for evaluating the value of unliquidated investments sold to the Liquidation Scheme for determining the investment manager's track record and for reporting to performance benchmarking agencies. <u>Step 2</u>: Following the required investor consent to launch the Liquidation Scheme, the investment manager needs to offer the AIF's unliquidated investments to potential buyers to secure a bid for at least 25% of the total value of each unliquidated investment from the original scheme. Two independent valuers must assess the unliquidated investments. <u>Step 3</u>: The bid received, and the valuation of unliquidated investments are disclosed to the investors. <u>Step 4</u>: The dissenting investors are given the option to fully exit the AIF from the bid arranged by the investment manager. <u>Step 5</u>: Any unsubscribed portion of the bid should be used to provide a pro-rata exit to non-dissenting investors. If the bidder or its related parties are investors in the AIF, they cannot be allowed to exit the AIF from the bid. <u>Step 6</u>: The AIF's unliquidated investments are sold to the Liquidation Scheme. <u>Step 7</u>: Units of the Liquidation Scheme are allotted to the AIF in line with Steps 4 and 5 detailed above. <u>Step 8</u>: The AIF distributes the Liquidation Scheme units to the investors in-specie and redeems the units held by the investors in the AIF. <u>Step 9</u>: The AIF is wound up in accordance with the AIF Regulations. The entire process must be completed before the AIF's Liquidation Period expires. Additionally, SEBI has stipulated that the value of the sale, to determine the manager's track record and for reporting to performance benchmarking agencies, will be:
	➢ <u>Bid Value</u> – If the investment manager arranges a bid of at least 25% of the value of unliquidated investments in the AIF.

	➢ INR 1 (Rupee One) – If the investment manager fails to arrange a bid of at least 25% of the value of unliquidated investments in the AIF.
	For an AIF operating as a fund-of-funds, if the investee AIF launches a Liquidation Scheme, the fund-of-funds must distribute the units of the Liquidation Scheme held by it, in-specie to its investors upon the expiry of its tenure (or extended tenure). Comment: While SEBI has provided a detailed process for winding up, there are still some practical questions concerning this process. A clarification from SEBI about whether this process should run simultaneously with the process for obtaining consent for in-specie distribution, or whether the investment manager has the discretion to choose between a Liquidation Scheme or in-specie distribution, would bring much-needed clarity. Moreover, a significant question remains about the exit of investors currently under investigation or involved in legal proceedings that prevent the investment manager from making distributions to them. For such investors, the investment manager should have the option to establish an escrow account to hold the proceeds to which these investors are entitled.
D)	**What is the process for distribution of unliquidated investments in-specie to investors?** The process for distribution of unliquidated investments in-specie to investors is as follows: Step 1: During the AIF's Liquidation Period, if the AIF decides to distribute unliquidated investments in-specie, the investment manager must secure the consent of 75% of the investors by value. The manager also needs to disclose the valuation methodology of the unliquidated investments intended for in-specie distribution, crucial for establishing their track record and reporting to performance benchmarking agencies. Step 2: Once investor consent is obtained, the bidding process, valuation, and subsequent exits provided to dissenting and non-dissenting investors, as detailed in steps 2, 3, 4, and 5, remain the same. Step 6: The AIF then proceeds with the in-specie distribution of unliquidated investments to investors and redeems their units in the AIF. Step 7: The AIF is wound up in accordance with the AIF Regulations. This entire process must be completed before the Liquidation Period of the AIF expires. SEBI stipulates that the method for determining the manager's track record and reporting to benchmarking agencies remains the same as for the Liquidation Scheme. Comment: The mandatory in-specie distribution requirement for both original and liquidation schemes of AIFs necessitate reconsideration. It overlooks practical complications, especially when transferring unliquidated investments to another scheme. Such transfers can be hindered by various factors, such as litigation that restricts securities transfer, ROFO obligations under investment documents, tax issues, and more. This is particularly challenging for foreign investors who might face regulatory hurdles and potential legal concerns. For instance, acquiring securities from Indian entities might need approval from the Reserve Bank of India, and in some cases, foreign investors may not be legally qualified to hold certain

	securities. This situation conflicts with recent SEBI guidelines. Furthermore, any investment transfers from foreign-owned and controlled AIFs, considered as 'indirect foreign investment,' must comply with foreign direct investment regulations. These limitations could lead to a hurried sale of unliquidated investments and restrict the possibility of extending the existing scheme's term, bypassing investor consensus.
E)	**What must be done in case the AIF fails to obtain investor consent for both liquidation scheme?** The SEBI Circular states that if an AIF fails to obtain necessary investor consent for the launch of a Liquidation Scheme or in-specie distribution of unliquidated investments, those investments must be compulsorily distributed in-specie to the investors, bypassing the consent requirement. The value of such investments distributed in-specie should be recorded as INR 1 (Rupee One) to document the manager's track record and for reporting to performance benchmarking agencies. Moreover, the SEBI Circular suggests that if an investor is unwilling to accept the in-specie distribution of unliquidated investments, such investments should be written off. Comment: SEBI has given a conclusive process for the winding up of AIFs by mandating that unliquidated investments must be distributed in-specie if the necessary investor consent for either option is not provided.

Comment

The Amendment Regulations represent a significant stride towards enhancing investor protection and fostering transparency in the private equity sector. By delineating a clear framework, SEBI aims to ensure fund managers uphold their commitments and fulfil their responsibilities even after the fund's tenure concludes. Additionally, it's important to highlight that the compliance obligation with the SEBI Circular lies with the investment manager, trustee, and the AIF's key management personnel. This expands the scope of SEBI's enforcement action, if AIFs fail to wind up the Fund within the stipulated timeframe, thereby boosting investors' trust and confidence in their investment decisions.

SEBI's establishment of a comprehensive process for initiating a liquidation scheme and distributing unliquidated investments in-specie is a commendable move. It signals SEBI's willingness to tackle the practical difficulties AIFs encounter when liquidating assets. It is also hoped that the Amendment Regulations will stimulate a broader discussion between investment managers and investors regarding the suitable fund life cycle for Indian markets, instead of adhering to the globally accepted 7 to 8-year tenure. This could result in a more patient and realistic flow of capital with a slightly extended tenure, which would aid investee companies in achieving the necessary operational scale and valuation for subsequent investment rounds.

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