

SEBI Introduces 'Inoperative Fund' Framework to Facilitate Orderly Winding Up of AIFs and VCFs

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Introduction

The Securities and Exchange Board of India (SEBI) through the circular HO/19/34/11(2)2026-AFD-POD1/I/13764/2026 dated 16 June 2026 (Circular) has issued guidelines for AIFs seeking 'Inoperative Fund' status. The Circular follows SEBI's consultation paper dated 5 February 2026 titled '*Flexibility to Alternative Investment Funds (AIFs) in Winding up the Scheme / Surrendering the Registration*', which proposed granting AIFs / VCFs greater flexibility to retain liquidation proceeds beyond the expiry of their permissible tenure in specified circumstances.

Prior to the issuance of the Circular, an AIF / Venture Capital Fund (VCF) was required to surrender its registration certificate upon expiry of its permissible tenure, subject to distribution of liquidation proceeds to investors and achievement of a NIL bank account balance. However, several AIFs faced challenges in meeting this requirement and continued to retain funds beyond their respective tenure due to pending or anticipated litigation, tax demands, untraceable investors or residual operational expenses.

Similar challenges have been faced by VCFs registered under the erstwhile SEBI (Venture Capital Funds) Regulations, 1996. In many cases, VCFs were unable to complete the surrender of their registration or obtain closure of the winding-up process where amounts continued to be retained on account of pending litigation, untraceable investors, tax contingencies or residual liabilities.

The Circular partially addresses these anomalies through the introduction of the 'Inoperative Fund' framework which also extends to VCFs registered under the erstwhile SEBI (Venture Capital Funds) Regulations, 1996.

Conditions for 'Inoperative Fund' Status

AIFs / VCFs are now allowed to retain liquidation proceeds beyond the permissible fund life subject to satisfaction of any of the following conditions:

- (i) ***Demonstrable litigation/tax demand***: The AIF / VCF must demonstrate that it has received a litigation notice or tax demand. This may include official communication from tax, regulatory or law enforcement authorities, courts, investor or other counterparties and includes show-cause notices, re-assessment notices, investigation summons, or similar communications, and not only crystallised demand notices.
- (ii) ***Anticipated liabilities***: In cases where the proceeds are proposed to be retained to address anticipated liabilities in relation to possible litigation or anticipated tax demands, the investment manager is required to obtain consent of at least 75% of the investors by value of their investment in the AIF/ VCF. While seeking such consent, the investment manager is obligated to disclose the amount proposed to be retained along with the estimated time period for such retention.
- (iii) ***Residual operational expenses***: Since the AIF /VCF may incur certain operational expenses as part of the winding up process, the investment manager may seek the status of an Inoperative Fund in order to retain such amount beyond the term of the AIF. In such cases, the investment manager

must substantiate the amounts proposed to be retained by way of presentation of invoices, supporting documents or records of similar expenses incurred previously. Such retention should not continue beyond 3 years from the end of the term of the AIF /VCF.

- (iv) No retained proceeds: An AIF /VCF that has not retained any liquidation proceeds beyond its tenure but continues to hold registration solely in anticipation of a favourable litigation outcome may also apply for 'Inoperative Fund' status.

Key Conditions and Ongoing Obligations for Inoperative Funds

- (i) Temporary investments of retained monies: The AIF which has been granted 'Inoperative Fund' status and has retained monies pursuant to the above conditions is required to invest such amounts only in temporary investments in accordance with Regulation 15(1)(f) of the AIF Regulations.
- (ii) Restriction on launching new schemes: Once the AIF has been granted Inoperative Fund status, the investment manager cannot launch a new scheme under the same AIF.
- (iii) Restriction on charging management fees: Once an AIF/ VCF has been granted Inoperative Fund status, the investment manager cannot charge management fees in respect of any of the schemes by such AIF/ VCF.
- (iv) Annual status report: AIFs/VCFs that have retained funds and are classified as Inoperative Funds are required to submit an annual status report to SEBI and the investors of the AIF/VCFs regarding the retained funds and outstanding liabilities, in the format prescribed in Annexure C of the Circular. The annual status report is also required to be submitted to SEBI through the SEBI Intermediary Portal within 30 calendar days from the end of March of each financial year.
- (v) Compliance exemptions: Inoperative Funds are eligible for certain regulatory and compliance exemptions, including exemptions from specified periodic filings and compliance requirements. The regulatory and compliance exemptions available to Inoperative Funds include the following:
- a. Limited Quarterly Activity Report and Annual Activity Report
 - b. Audit of terms of PPM and intimation of changes in the PPM
 - c. Intimation of changes in PPM
 - d. Compliance Test Report (CTR)
 - e. Reporting of information, including scheme-wise valuation and cash flow data to the Benchmarking Agencies for performance benchmarking
 - f. NISM certification requirement for the key investment team of the fund
 - g. Requirement of custodian for safekeeping of securities of AIF
 - h. Periodic disclosure to investors regarding fund investments in terms of Regulation 22(a) of AIF Regulations
 - i. Annual (Category I and II AIFs) /Quarterly reports (Category III AIFs) to investors
 - j. Valuation of investments of AIFs
- (vi) Surrender of registration: Once the liabilities of the Inoperative Fund have been satisfied and the proceeds are distributed to the investors, the AIF should apply for surrender of its certificate of registration.

Application Process

An AIF intending to continue as an Inoperative Fund may apply for obtaining such status by emailing its application in the format of Annexure A of the Circular to inoperativeaif@sebi.gov.in.

Our Analysis

While the Circular addresses a long-standing operational issue faced by AIFs / VCFs at the end of their permissible fund life, certain aspects of the framework may require further clarification from SEBI to ensure that the relief does not create unintended constraints for investment managers, particularly in the context of AIFs / VCFs with multiple schemes.

The Circular appears to contemplate that 'Inoperative Fund' status would be granted at the AIF / VCF level, rather than at the respective scheme level. This distinction could have significant implications for AIFs /VCFs operating multiple schemes under a single registration. If the status is granted at the AIF level, the investment manager will be precluded from launching new schemes and will be restricted from charging management fees in respect of any of its schemes.

The Circular does not fully address certain practical challenges that commonly arise at the final stages of fund winding-up. For instance, VCFs frequently encounter situations where distributions cannot be completed because certain investors have become untraceable or because transmission of units remains pending following the death of an investor. In the absence of a prescribed mechanism for dealing with such situations, VCFs/AIFs may continue to face difficulties in achieving a NIL bank balance, completing distributions and surrendering their registration.

While the Circular expressly provides for the applicability of certain provisions of the Inoperative Fund framework to VCFs, the process for obtaining Inoperative Fund status (including the application format prescribed in Annexure A of the Circular) appears to be available only to AIFs. The industry awaits clarity from SEBI on the application process for VCFs as well.

Further, the Circular does not expressly address its applicability to AIFs or erstwhile VCFs that had commenced winding-up or registration surrender processes prior to the issuance of the Circular but continue to be affected by pending litigation, tax proceedings, regulatory demands, or other operational liabilities. Specific guidance on the treatment of such transitional cases would assist in ensuring regulatory certainty and consistent treatment across similarly situated funds.

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