New SEBI Rules for Retention of Proceeds and 'Inoperative Fund' Status for AIFs

The Securities and Exchange Board of India (**SEBI**) has issued a circular dated June 16, 2026 (**June Circular**) to set out (i) rules for the retention of liquidation proceeds by schemes of Alternative Investment Funds (**AIF**) at the time of winding up and (ii) the process by which an AIF may obtain an 'Inoperative Fund' status.

SEBI rule for liquidation of scheme assets on expiry of term:

Regulation 29 (7) of the SEBI (Alternative Investment Fund) Regulations, 2012 (**AIF Regulations**) prescribes that after an AIF scheme's term expires, the assets of the scheme should be liquidated within the '*liquidation period*' and the proceeds distributed to investors in the AIF scheme after satisfying all liabilities of the scheme. Regulation 2(1) (pb) of the AIF Regulations defines Liquidation Period as a period of one year following the expiry of the tenure of the scheme.

Regulation 29(9) provides that, during the liquidation period, an AIF may either distribute to investors in-specie any scheme investments that remain unsold for lack of liquidity, or enter into a '*dissolution period*', after obtaining the approval of at least seventy-five per cent of investors by value, in the manner and subject to the conditions specified by SEBI from time to time.

"Dissolution Period" has been defined under Regulation 2(ia) to mean the period following the expiry of the liquidation period of the scheme for the purpose of liquidating the unliquidated investments of the scheme of the Alternative Investment Fund.

Regulation 29(11) of the AIF Regulations provides that upon winding up of the AIF, its certificate of registration shall be surrendered to the Board.

Grounds for retaining liquidation proceeds beyond permissible fund life:

The June Circular provides that AIFs and schemes of AIFs may retain liquidation proceeds beyond the end of permissible fund life (which is the end of the liquidation period or the dissolution period, as the case may be), provided one of the following three conditions are satisfied:

- Demonstrable receipt of a litigation notice or demand by the AIF/scheme of AIF, which includes any official written communication from a tax authority, regulatory authority, law enforcement agency, court of law, or from an investor or counterparty in relation to litigation, which indicates a potential tax, regulatory or legal liability. This shall include show-cause notices, reassessment notices, investigation summonses, or similar communications and shall not be restricted to crystallised demand notices;
- Consent obtained from at least seventy-five per cent of the investors by value of their investment in the scheme, in cases where proceeds are proposed to be retained on account of anticipated liabilities arising due to a possible/probable litigation or tax demand. In cases where monies are being retained by an AIF under this ground, the manager of the AIF shall disclose the amount being retained and the estimated time period for which it is proposed to be retained to the investors of the fund while seeking their consent for retention;
- Substantiation of amounts retained for meeting residual winding-up-related operational expenses, through invoices, supporting documents or records of comparable expenses incurred in previous years. In cases where monies are being retained by an AIF on this ground, the time period for such retention shall not exceed three years from the end of the permissible fund life of the AIF/scheme of the AIF.

Eligibility and process to obtain "Inoperative Fund" status:

An AIF may apply for "Inoperative Fund" status in the following circumstances:

- One or more schemes of the AIF have retained monies from their liquidation proceeds in accordance with the guidelines given in the June Circular; or
- The AIF intends to retain its registration solely in anticipation of a favourable outcome of a pending litigation, even though the schemes of the AIFs have not retained monies from their liquidation proceeds.

The application for 'Inoperative Fund' status should be submitted to SEBI by emailing inoperativeaif@sebi.gov.in in the format specified in Annexure A of the June Circular. Once SEBI approves the AIF's application, the AIF will be tagged as an 'Inoperative Fund'.

Reduced compliance burden for Inoperative Funds:

Once an AIF is tagged as an 'Inoperative Fund':

- The monies retained by scheme(s) of such AIF shall be invested in accordance with Regulation 15(1)(f) of the AIF Regulations;
- No new scheme shall be launched by the AIF; and
- The AIF cannot charge any management fees in respect of any of its scheme(s).

Once an AIF is tagged as an 'Inoperative Fund', various compliance obligations fall away. The full list of requirements that no longer apply to Inoperative Funds is set out in Annexure B of the June Circular. The most significant of these are:

- Filing of limited quarterly activity report and annual activity report obligations;
- Compliance Test Reports (CTR);
- Periodic investor reporting under Regulations 22(a), 22(g) and 22(h);
- NISM certification, custodian requirement, and routine valuation/reporting obligations.

Annual Reporting

AIFs having schemes that have retained monies in accordance with the June Circular and AIFs tagged as 'Inoperative Funds' have to submit an annual status report (on retained monies and outstanding liabilities) to SEBI and to the investors of the relevant scheme(s), in the format as given at Annexure C of the June Circular. This report has to be submitted through the SEBI Intermediary portal within 30 calendar days from the end of March of every financial year.

ELP Comments

- *The June Circular is the final step in a sequence that began earlier this year. On February 5, 2026, SEBI has issued a consultation paper dated ("Consultation Paper") seeking public comments on proposals aimed at streamlining the processes pertaining to the winding up of AIF schemes and the surrender of AIF registrations. Pursuant to the Consultation Paper, on March 23, 2026, SEBI's Board approved (i) amendments to the AIF Regulations to permit AIF schemes to retain the liquidation proceeds of their portfolios post completion of their tenure in certain specific circumstances and (ii) a framework for tagging certain AIFs as 'inoperative funds' with lighter compliance requirements till the surrender of their registration certificates. To implement this, on April 16, 2026, SEBI had notified amendments to the AIF Regulations to give itself the power to prescribe rules for the retention of monies by AIFs post the AIF's permissible fund life and the process for obtaining an 'Inoperative Fund' status. The June Circular has been issued by SEBI on the basis of the amendments made to the AIF Regulations on April 16, 2026, and largely reflects the proposals in the Consultation Paper.*
- *Of the three grounds provided by the June Circular under which an AIF can retain monies post its permissible fund life, the first two grounds have a fair amount of overlap. Under both grounds, an AIF scheme can retain monies from outside its liquidation proceeds to meet any demand from the tax authorities or any regulator or to make payment to a third party. However, what separates them is how far the claim against the AIF has progressed. To be covered by the first ground, the demand has to be demonstrable, meaning the actual demand or legal notice ought to have*

been received. Under the second ground, monies can be retained on account of anticipated liabilities provided at least 75% of the investors by value of their investment in the scheme, consent to such retention. It is interesting to note that investor consent is not, on its own, sufficient. Even if there is 100% consent from the investors of the scheme, the liquidation proceeds cannot be retained beyond the permissible fund life unless there is a possible/probable litigation or tax demand.

- *The investment manager of an AIF can withhold all or a portion of the liquidation proceeds in order to meet residual winding-up-related operational expenses. The consent of investors is not required in this regard. However, monies cannot be retained under this ground for more than three years from the end of the permissible fund life of the AIF/scheme of AIF.*
- *Retention of liquidation proceeds and "Inoperative Fund" status are distinct. An AIF that has retained liquidation proceeds of a scheme beyond the end of permissible fund life in accordance with the June Circular does not automatically become an Inoperative Fund. To be classified as an "Inoperative Fund", an application has to be made to SEBI for this purpose, and such an application has to be approved by SEBI. Therefore, it is possible that an AIF may retain liquidation proceeds of a scheme beyond the end of permissible fund life and does not apply to become an Inoperative Fund.*
- *Once an AIF is tagged as an Inoperative Fund, valuation and reporting obligations fall away. However, if the Inoperative Fund has retained any money, the annual retention status report (given in Annexure C of the June Circular) still requires the "Latest Value of Holding as at the end of the reporting period". For this purpose, the valuation considered for the calculation of the Scheme's latest NAV has to be provided.*
- *The June Circular states that all monies retained beyond the permissible fund life under one of the three grounds specified by the June Circular shall be invested in accordance with Regulation 15(1)(f) of the AIF Regulations. Regulation 15(1)(f) states as follows:*

  > *"Un-invested portion of the investable funds and divestment proceeds pending distribution to investors may be invested in liquid mutual funds or bank deposits or other liquid assets of higher quality such as Treasury bills, Triparty Repo Dealing and Settlement, Commercial Papers, Certificates of Deposits, etc. till the deployment of funds as per the investment objective or the distribution of the funds to investors as per the terms of the fund documents, as applicable."*

  Even if the June Circular did not expressly specify that monies retained beyond the permissible fund life should be invested in accordance with Regulation 15(1)(f), it is clear that Regulation 15(1)(f) would have applied to any retained funds on account of the words "divestment proceeds pending distribution to investors" in Regulation 15(1)(f).

The June Circular can be found here.

The minutes of SEBI's Board meeting held on March 23, 2026, can be found here.

The Consultation Paper can be found here.

SEBI's amendments to the AIF Regulations, which were notified on April 16, 2026, can be found here.

We hope you have found this information useful. For any queries/clarifications, please write to us at insights@elp-in.com or write to our authors:

Vinod Joseph, Partner – Email - vinodjoseph@elp-in.com

Paridhi Jain, Senior Associate – Email – paridhijain@elp-in.com