Investment Funds: Monthly Digest

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FROM VCFS TO MVCFS: SEBI'S NEW FRAMEWORK EASES TRANSITION AND ENHANCES FLEXIBILITY

- Migrated Venture Capital Fund introduced as a sub-category under Category I Alternative Investment Funds for Venture Capital Funds seeking to migrate to the AIF framework from the erstwhile VCF Regulations.
- Minimum disclosures in the PPM mandated; No registration fees; No additional investment restrictions for Migrated Venture Capital Fund as applicable to a Category I – VCF.
- Also introduced provisions for extension of tenure and winding up of Migrated Venture Capital Funds.

INTRODUCTION

Venture Capital Funds ("**VCFs**") are instrumental in nurturing the development of emerging industries by infusing capital into high-risk, high-reward start-ups. Unlike traditional financing sources, venture capitalists invest in innovative ventures that have the potential to offer significant returns, but also carry with them significant risk. VCFs not only fuel innovation but also accelerate the growth of emerging businesses, driving progress in various sectors. In 1996, the Securities and Exchange Board of India ("**SEBI**") to encourage investment and funding in early-stage companies in India, notified SEBI (Venture Capital Funds) Regulations 1996[1] ("**VCF Regulations**").

Later in the year 2012, SEBI introduced SEBI (Alternative Investment Funds) Regulations, 2012 ("**AIF Regulations**") in an effort to provide for a more inclusive, clear, and robust regulatory framework that could better accommodate the diverse and evolving landscape of alternative investments in India. With the introduction of the AIF Regulations, the VCF Regulations were repealed. However, existing VCFs continued to be regulated under the VCF Regulations under specific conditions. These conditions included prohibiting the launch of any new schemes by VCFs after the notification of the AIF Regulations and preventing any increase in the targeted corpus of the fund or its schemes post such notification. Additionally, the AIF Regulations provided an option for VCFs to re-register under the Alternative Investment Fund ("**AIF**") framework, contingent upon obtaining approval from 2/3rd of their investors by value.

SEBI has recently notified certain amendments to AIF Regulations to facilitate the migration of VCFs under the framework of AIF Regulations. In this issue of the monthly digest, we will discuss the background and implications of the amendments.

BACKGROUND

Despite the provision for seeking re-registration under the AIF Regulations, many VCFs continued to operate under the VCF Regulations. Over time, SEBI received numerous requests from VCFs and their trustees highlighting various difficulties faced by VCFs. One major issue was related to the maturity period of funds, which, as per the Private Placement Memorandums ("**PPMs**") of a VCF, dictated that the scheme of a VCF set up as a trust must be wound up once the period mentioned in the PPM is over. This meant that the tenure of the VCF was strictly based on the terms of the PPM, with no provision in the VCF Regulations governing the extension of tenure of the VCF.

Additionally, there was no express provision in the VCF Regulations for the surrender of a registration certificate even after winding up schemes. Consequently, as of June 30, 2023, out of 179 registered VCFs, only 49 had submitted their quarterly investment report for the quarter ending on June 30, 2023, while the remaining VCFs had either wound up, not commenced operations, or defaulted on reporting requirements. Furthermore, many PPMs did not disclose a specific timeframe for winding up the VCF, leading to misinterpretations and VCFs continuing operations indefinitely without any restriction.

Moreover, the recently introduced provisions for opting for a dissolution period to liquidate investments apply only to AIFs. Consequently, there was no specific mechanism for liquidation available for VCFs. For more details, please refer to our digest on dissolution period. This posed a significant challenge for VCFs in effectively managing their unliquidated investments.

AMENDMENTS IN AIF REGULATIONS

To address the multiple issues faced by VCFs, on January 12, 2024, SEBI released a consultation paper inviting public comments on the proposed framework for facilitating VCF migration into AIFs. Following the consultation paper, SEBI approved the new framework during its board meeting on April 30, 2024. SEBI introduced a new framework under the SEBI (AIF) (Third Amendment) Regulations, 2024. This amendment includes a new chapter, Chapter III-D, dedicated to "Migrated Venture Capital Funds" ("**MVCFs**"), which facilitates the transition of VCFs into the AIF framework.

MVCFs have been defined as funds previously registered under the VCF Regulations and are now re-registered as a

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sub-category under Category I AIFs, adhering to the provisions set out in this new chapter. To obtain registration, MVCFs must meet several eligibility criteria. These include holding a valid certificate under the VCF Regulations, being deemed a fit and proper person, providing requisite information to the SEBI, and ensuring no pending investor complaints about non-receipt of funds or securities. Additionally, MVCFs must ensure that no scheme accepts investments of less than INR 5 lakhs and that each scheme raises investor commitments of at least INR 5 crores. MVCFs are provided certain exemptions under the AIF Regulations. MVCFs are *inter alia* exempted from the minimum investment requirement in AIFs, minimum corpus size requirement, continuing interest requirement for sponsors and maximum number of investors in a scheme.

However, in terms of disclosure, MVCFs are mandated to provide minimum disclosures in their PPMs to be filed with SEBI. Firstly, they are required to provide detailed information about the trustees or trustee companies, including the directors or chief executives of the MVCF. The fund's corpus is also required to be specified, highlighting the minimum amount required to make the fund operational and the minimum amount needed for each scheme, along with provisions for refunding investors if these minimum amounts are not met. Further, the placement memorandum should outline the entitlements associated with the units of the MVCF being subscribed to and clearly describe the tax implications for investors. Additionally, the placement memorandum should specify the MVCF's maturity period, if applicable, and the process for winding up the MVCF if necessary. In addition to the above, information about the fund manager or asset management company, including associated fees, is required to be provided. Moreover, the performance of any fund managed by the fund manager is required to be disclosed, along with the MVCF's investment strategy.

Regarding investment criteria, unlike Category I – Venture Capital Funds, SEBI has retained the status quo of MVCFs by mandating them to invest at least 66.67% of their investable funds in unlisted equity shares or equity-linked instruments of venture capital undertakings (as compared to 75% in case of Category I – Venture Capital Funds). Further, up to 33.33% of the funds may be allocated to other investments, including subscription to initial public offerings (IPOs) of venture capital undertakings, debt or debt instruments of previously equity-funded venture capital undertakings, preferential allotments of equity shares with a one-year lock-in, and investments in financially distressed or sick industrial companies listed on stock exchanges. Additionally, MVCFs are required to invest no more than 25% of the MVCF's corpus in a single venture capital undertaking and are prohibited from investing in associated companies.

Further, SEBI is yet to notify the methodology for specifying the tenure of an MVCF. However, keeping in line with the AIF framework, SEBI has now mandated MVCFs to extend their tenure for up to two years, with the approval of two-thirds of the unit holders based on the value of their investments. Should the unit holders not consent to the extension, or upon the expiry of any extended tenure, the fund or its scheme must be wound up per Regulation 29 of the AIF Regulations. Furthermore, if a scheme of a venture capital fund, which is registered under the VCF Regulations has not been liquidated by the end of its tenure as outlined in sub-regulation (2) of Regulation 24 of the VCF Regulations, and if the VCF has subsequently been registered as a MVCF under the AIF regulations, such schemes may be granted an additional liquidation period. This extension will be subject to conditions and procedures established by the SEBI.

ANALYSIS

SEBI's integration of VCFs into the AIF framework has introduced a more structured and streamlined approach, enhancing operational efficiency for VCFs. Notably, SEBI has imposed strict penalties on VCFs that continue operations beyond their planned terms. A recent example is the adjudication order issued on February 21, 2024, against the India Growth Fund, a scheme of the Kotak SEAF India Fund. This case underscores SEBI's firm stance on preventing tenure extensions for VCFs, following its earlier action in 2019 against Cinema Capital Venture Fund, which the Securities Appellate Tribunal upheld in 2021.

Due to unresolved litigation involving its portfolio companies, the investment manager of India Growth Fund extended the fund's duration past its original end date, believing that forced liquidation would harm investors. Despite this, SEBI insisted on adhering to the fund's original tenure. SEBI concluded that extending the fund's life beyond the specified term in the PPM on three occasions violated Regulation 23(1)(a) of the VCF Regulations read with Regulation 39 of the AIF Regulations, implicating the VCF, its investment manager, and the trustee.

Hopefully, the new provisions including the ability to extend the VCF's tenure and providing additional liquidation periods, will resolve these issues offering the VCFs greater flexibility in managing unliquidated investments. The removal of registration fees for migration and the absence of extra investment conditions applicable to AIFs significantly lower the barriers to entry and operational costs, encouraging VCFs to transition to the AIF structure.

These changes are designed to simplify regulatory compliance and oversight, providing VCFs with clearer processes and extended timelines, such as the option for a two-year tenure extension subject to unit holder approval. This added clarity and adaptability are likely to foster a more favourable environment for VCFs. However, maintaining adherence to the revised regulations will be vital for ensuring that the benefits of this transition are fully realized. Ongoing SEBI oversight will play a crucial role in addressing any emerging challenges and mitigating the growing regulatory scrutiny on VCFs

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[1] https://www.sebi.gov.in/sebi_data/commondocs/vcfnew_p.pdf