Overview of Regulatory & Legal Aspects of VCF / FVCI and making Investments in India

by

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27th March 2007

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Why Venture Capital?

- Its a critical resource for supporting innovation, knowledge based ideas and technology and human capital intensive enterprises
- High risk / high return finance combined with hand holding
- Supports first generation entrepreneurs by providing the equity capital needed for idea based enterprises generally not available from banks and institutions
- Now expansions plans of big companies attracting VC/PE – Overseas acquisitions

EVOLUTION OF VC & VC REGULATORY CLIMATE IN INDIA

- **Worldwide VC has been major driver of Innovation, Economic growth, Knowledge based industry and Start ups. US & Israel have robust economic system & supportive legal framework**

- **In November 1988 guidelines were issued by (then) Controller of Capital Issues, stipulating the framework for establishment and operation of funds/companies.**

EVOLUTION OF VC …….. continued

- **1988 – Technical Development and Information Corporation of India (TDICI, now ICICI Ventures) was set up**

- **Soon followed by Gujarat Venture Finance Ltd.**

- **Both these organization were promoted by Financial institutions**

EVOLUTION OF VC …….. continued

- There was no major VC till mid 90's, as one of the reason was unfriendly Policy & Regulatory framework.

- In 1999, a committee on VC was set up headed by K.B. Chandrasekhar an Indian entrepreneur from Silicon Valley and other experts from India to provide a global perspective on Venture Capital

EVOLUTION OF VC …….. continued

- **SEBI introduced SEBI (Venture Capital Fund) Regulations in 1996 for regulating and promoting activities of domestic VCFs**

- **In 2000 SEBI introduced SEBI (Foreign Venture Capital Fund) Regulations enabling foreign venture capital and private equity investors to register with SEBI and avail certain benefits provided there under**

EVOLUTION OF VC …….. continued

- **Finance Act 1995, 1999 and lastly 2000 fueled the growth of VCF/FVCI by inserting section 10(23FB) and 115U in Income Tax Act**

- **Advisory Committee under Chairmanship of Dr.Ashok Lahiri gave its report in 2003, which helped SEBI in considering the amendments in the regulations that facilitated further the development of vibrant VC industry in India**

- **Reforms over the years have resulted increase in inflow of VC/PE from $500 mn in 1999 to around $7 bn last year**

VCF
FVCI

SEBI

- SEBI Act, 1992
- SEBI (VCF) Reg. 1996
- SEBI (FVCI) Reg. 2000
- SCR Act,1956
- SEBI (SAST) Reg.1997
- SEBI (DIP) Guidelines, 2000

RBI

- FEMA 1999
- Transfer or Issue of Security by a Person Resident Outside India Regulations 2000

FIPB

- FDI Policy
- Investment Approvals
- Press Notes

TAX

- IT Act, 1961
- DTAA
  - Singapore
  - Mauritius

SEBI

- Security Exchange Board of India Act, 1992 {SEBI Act}
- SEBI (Venture Capital Funds) Regulations, 1996
- SEBI (Foreign Venture Capital Investors) Regulations, 2000
- Securities Contract (Regulation) Act, 1956
- SEBI (Substantial Acquisition of Shares & Takeover) Regulations, 1997
- SEBI (Disclosure of Investor Protection) Guidelines, 2000

Definitions

Venture Capital Fund (VCF) - means a fund established in the form of a trust or a company including a body corporate and registered under these regulations which

(*i*) has a dedicated pool of capital;

(*ii*) raised in a manner specified in the regulations; and

(iii) invests in accordance with the regulations.

Venture Capital Undertaking (VCU) means a domestic company—

(i) whose shares are not listed on a recognized stock exchange in India;

(ii) which is engaged in the business for providing services, production or manufacture of article or things or does not include such activities or sectors which are specified in the negative list by the Board with the approval of the Central Government by notification in the Official Gazette in this behalf.

Foreign Venture Capital Investor (FVCI) means an investor incorporated and established outside India, registered under these Regulations and proposes to make investment in accordance with these Regulations.

Domestic Custodian means a person registered under the Securities and Exchange Board of India (Custodian of Securities) Regulations, 1996.

Venture Capital Company (VCC) means such company

1. which has been granted a certificate of registration under the SEBI Act, 1992 and regulations made thereunder;

2. which fulfils the conditions as may be specified, with the approval of the Central Govt, by the SEBI, by notification in the Official Gazette, in this behalf. (Sec 10(23)(FB), ITA

Company means ……any body corporate incorporated by or under the laws of a country outside India…..(Sec 2(17)(ii), (ITA)

Associate Company, means a company in which a director or trustee or sponsor or settlor of the venture capital fund or asset management company holds either individually or collectively, equity shares in excess of 15 % of the paid-up equity share capital of venture capital undertaking.

Equity Linked Instruments includes instruments convertible into equity shares or share warrants, preference shares, debentures compulsorily *or optionally* convertible into equity.

Negative List (Schedule of III)

1. Non-banking financial services excluding those NBFCs which are registered with Reserve Bank of India and have been categorized as Equipment Leasing or Hire Purchase Companies.
2. Gold financing excluding those Companies which are engaged in gold financing for jewellery.
3. Activities not permitted under industrial policy of Government of India.
4. Any other activity which may be specified by the Board in consultation with Government of India from time to time.

Security Exchange Board of India Act, 1992 {SEBI Act}

Section 12(1B)

No person shall sponsor or cause to be sponsored or carry on or cause to be carried on any venture capital funds or collective investment schemes including Mutual Funds, unless he obtains a certificate of registration from the Board in accordance with the regulations…..

SEBI (Venture Capital Funds) Regulations 1996
SEBI (Foreign Venture Capital Investors) Regulations 2000

Who can apply for VCF: Company / Trust / Body Corporate

Eligibility Criteria for VCF

- MOA/Trust Deed must have main object to carry on activity of VCF
- Prohibition by MOA & AOA for making an invitation to the public to subscribe to its securities
- Director / Principal Officer / Employee / Trustee is not involved in any litigation connected with the securities market
- Director / Principal Officer / Employee / Trustee has not at any time been convicted of any offence involving moral turpitude or any economic offence
- The applicant is a fit and proper person
- In case of, Body Corporate, it must have been set up under Central or State legislations
- Applicant has not been refused certificate by SEBI (rule – 4)

Considerations for FVCI registration

1. Applicant's track record, professional competence, financial soundness, experience, general reputation of fairness and integrity; or
2. Applicant has approval from RBI for making investments in India;
3. Whether the applicant is an investment company, investment trust, investment partnership, pension fund, mutual fund, endowment fund, university fund, charitable institution or any other entity incorporated outside India; or
4. Whether the applicant is
   a. an AMC, investment manager or investment management company or any other investment vehicle incorporated outside India
   b. authorized to invest in VCF or carry on activity as a FVCI
   c. regulated by an appropriate foreign regulatory authority or is an income tax payer; or submits a certificate from its banker of its or its promoter's track record where the applicant is neither a regulated entity nor an income tax payer; or
5. Whether the applicant is a fit and proper person (rule – 4)

Minimum investment in a Venture Capital Fund

- A VCF may raise monies from any investor whether Indian, Foreign or Non-resident Indian by way of issue of units

- No VCF shall accept any investment from any investor which is less than 5 Lac, except from employees / principal officer / directors / trustee of the VCF or the employees of the fund manager or AMC

- VCF shall have firm commitment of at least 5 crores from the Investors before the start of operations by the VCF

Investment Conditions & Restrictions

- VCF shall disclose investment strategy to SEBI before registration
- VCF shall not invest more than 25% of the funds in one VCU. FVCI can invest its total funds in one VCU
- No investment in associated companies
- VCF/FVCI shall disclose duration of the life cycle of the fund
- At least 66.67% of the investible funds shall be invested in unlisted equity shares or equity linked instruments of VCU

Investment Conditions & Restrictions

- Not more than 33.33% of the investible funds may be invested by way of
  - subscription to IPO of a VCU
  - debt or debt instrument of a VCU in which VCF has already made an investment by way of equity
  - preferential allotment of equity shares of a listed company subject to lock in period of one year
  - the equity shares or equity linked instruments of a financially weak company or a sick industrial company whose shares are listed.
  - SPV which are created by VCF for the purpose of facilitating investment

Restriction on listing

No VCF shall be entitled to get its units listed till the expiry of 3 years from the date of the issuance of units.

Prohibition on inviting subscription from the public

No VCF shall issue any document or advertisement inviting offers from the public for the subscription or purchase of any of its units

Private placement

A VCF may receive monies for investment in the VCF only through private placement of its units

Appointment of Custodian

FVCI or a global custodian acting on behalf of the FVCI shall enter into an agreement with the domestic custodian to act as a custodian of securities for FVCI

Appointment of Designated Bank

FVCI shall appoint a branch of a bank approved by RBI as designated bank for opening of foreign currency denominated accounts or special non-resident rupee account

SEBI (Substantial Acquisition of Shares and Takeovers) Regulations, 1997

Nothing contained in **Regulations 10, Regulation11 and Regulation 12 of SAST** shall apply to transfer of shares from VCFs or FVCIs registered with the SEBI to promoters of a venture capital undertaking or venture capital undertaking pursuant to an agreement between such VCF or FVCIs with such promoters or VCU

SEBI (Disclosure and Investor Protection) Guidelines, 2000

Lock-in on Pre- IPO shares before IPO held by VCFs & FVCI, Except

- shares held by VCFs or FVCIs registered with SEBI, for a period of at least one year as on the date of filing draft prospectus with SEBI;

- shares issued to SEBI registered VCFs/ FVCIs upon conversion of convertible instruments during the period of one year prior to the date of filing draft prospectus with SEBI, provided that the period of holding such convertible instruments as fully paid up, together with the period of holding shares resulting from conversion, by the VCFs and FVCIs, is at least one year as on the date of filing the draft prospectus with SEBI. (SEBI circular dated 16 Oct'06)

Benefits of FVCI Registration with SEBI

- Exemption from usual share valuation practice. It could be negotiated price.
- SAST do not apply to the shares transferred from FVCI to the promoters or to the company itself, if effected as per pre-existing agreement between FVCI & promoters of the company. If promoters buy back the shares from FVCI then no requirement of public offering.
- Qualified Institutional Buyer “QIB” status as per SEBI(DIP) guidelines. Can subscribe securities at IPO of a VCU through book-building process.
- Tax exemptions
- Exemption from prior Govt. approval under Press Note 1 of 2005

FEM (Transfer or Issue of Security by a Person Resident Outside India) Regulations 2000

INVESTMENT BY FVCI

(Schedule 6)

- FVCI may, through SEBI, apply to RBI for permission to invest in IVCU / VCF / scheme floated by such VCFs
- After RBI approval, FVCI can purchase equity / equity linked instruments/ debt / debt instruments, debentures of a IVCU / VCF through IPO or Private Placement or in units of schemes/funds set up by a VCF.
- Consideration for investment has to be paid out of inward remittance from abroad through normal banking channels or out of funds held in an account maintained with the designated Bank.

Maintenance of Account by FVCI for investment in IVCU/VCF

RBI may allow a FVCI, which has received ‘in principle’ registration from SEBI, to open a Foreign Currency Account and/or a Rupee Account for the following transactions:

1. Crediting inward remittance received through normal banking channels or the sale proceeds (net of taxes) of investments.
2. Making investment as per these guidelines.
3. Transferring funds from the Foreign Currency Account of the FVCI to their own Rupee account.
4. Remitting funds from the Foreign Currency or rupee account subject to payment of applicable taxes.
5. Meeting local expenses of the FVCI.

Forward Cover

Banks may offer forward cover to FVCIs to the extent of total inward remittance. In case the FVCI has made any remittance by liquidating some investments, original cost of the investments will be deducted from the eligible cover.

Valuation of Investments

The FVCI may acquire by purchase or otherwise or sell shares / convertible debentures / units or any other investment held by it in the IVCUs or VCFs or schemes / funds set up by the VCFs at a price that is <u>mutually acceptable to the buyer and the seller/issuer.</u>

FIPB

- **Sector Specific Foreign Direct Investment Policy**
  http://dipp.nic.in/publications/fdi_policy_2006.pdf

- **FIPB Investment Approvals**

- **Press Notes from time to time**
  http://siadipp.nic.in/policy/changes.htm

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INCOME TAX ACT 1961

Section 10 (*23FB*) – Tax Exemption

As per this section any income of a venture capital company (VCC) or venture capital fund (VCF) set up to raise funds for investment in a venture capital undertaking (VCU), shall not be included in the total income.

(*a*) VCC means such company

(*i*)which has been granted a certificate of registration by SEBI

(*ii*)which fulfils the conditions of SEBI Guidelines

(*b*) VCF means such fund

(*i*)operating under a trust deed registered under the provisions of the Registration Act, 1908 or operating as a Venture Capital Scheme made by the Unit Trust of India established under the Unit Trust of India Act, 1963

(*ii*)which has been granted a certificate of registration by SEBI

(i*ii*)which fulfils the conditions of SEBI Guidelines

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Chapter XII-F Section 115 U

Special provisions relating to tax on income received from VCCs & VCFs

(1) ….any income received by a person out of investments made in a VCC or VCF shall be chargeable to income-tax in the same manner as if it were the income received by such person had he made investments directly in the VCU.

(2) The person responsible for making payment of the income on behalf of a VCC or a VCF and the VCC or VCF shall furnish, within such time as may be prescribed, to the person receiving such income and to the prescribed income-tax authority, a statement in the prescribed Form 13 and verified in the prescribed manner, giving details of the nature of the income paid during the previous year and such other relevant details as may be prescribed.

(3) The income paid by the VCC and the VCF shall be deemed to be of the same nature and in the same proportion in the hands of the person receiving such income as it had been received by, or had accrued to, the VCC or the VCF, as the case may be, during the previous year.

(4) The provisions of Chapter XII-D or Chapter XII-E or Chapter XVII-B shall not apply to the income paid by a VCC or VCF under this Chapter.

Explanation. For the purposes of these Chapter, VCC, VCF and VCU shall have the meanings respectively assigned to them in clause (23FB) of section 10

Change proposed in Budget 2007- 08

Pass-through status to be granted to VCF only in respect of investments in VCU in biotechnology; information technology relating to hardware and software development; nanotechnology; seed research and development; research and development of new chemical entities in the pharmaceutical sector; dairy industry; poultry industry; and production of bio-fuels, and hotel-cum-convention centers of a certain description and size.

Effect of budget on VC Industry

- Innovation driven following sectors will be adversely effected

  - KPO/BPO
  - Telecom
  - Wireless value added services
  - Media and entertainment
  - Healthcare
  - Medical devices
  - Automobile Components ..etc

Effect of budget …. continued

- Domestic VCF will suffer more as compared to Foreign VC
  - Foreign funds investing in India will not be affected as most of are set up in tax neutral jurisdiction like Mauritius or Singapore and will have benefit of DTAA
  - On the other hand SEBI registered Domestic VCF will be limited to prescribed sectors and will be deprived of other sectors as there will be no tax exemptions.

Effect of budget …. continued

- Domestic VCF may be unable to raise money for the sectors impacted by budget, as majority of the funds raised by the domestic VCF is from overseas. Now the preference of overseas investors would be Foreign VC funds.

- Seed / Early stage investment will be adversely affected. Foreign funds mainly provide VC in growth stage. It is domestic VCF which largely invest in seed stage.

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SINGAPORE ROUTE

Double Taxation Avoidance Agreement (1994)

CECA Comprehensive Economic Cooperation Agreement 29 June,05

- Capital gains on disposal of equity investment in India by a Singapore resident will not be taxed in India. As Singapore does not tax capital gains, this treaty is beneficial to Singapore residents who invest in India

  Not applicable on gains from disposal of immovable property or movable business property attributable to a Permanent Establishment or a fixed base for the purpose of performing independent personal services

SINGAPORE ROUTE

Double Taxation Avoidance Agreement (1994)

CECA Comprehensive Economic Cooperation Agreement 29 June,05

- No capital gain tax exemption to shell / conduit Singapore company. A Singapore company will not be treated shell or conduit if :
  - It is listed on a recognized stock exchange of Singapore; or
  - Its total annual expenditure on operations in Singapore is at least S$2,00,000 in the immediately preceding period of 24 month from the date of gain arose

MAURITIUS ROUTE

Double Taxation Avoidance Agreement (1983)

There is no capital gains tax either in India or Mauritius on the sale of shares of the Indian Company by a Mauritius company

Presently in India there is no capital gain tax on sales of shares held over one year sold through stock exchange and there is 10% tax on short term capital gains

Investment through Mauritius is most beneficial when the Indian company is primarily exit vehicle for investor liquidity and such exit is likely to be private sale.

Further development required in legal framework

- Flexible Structure - LLP / LLC
  - VC Fund are set up for limited life and on maturity returns are distributed amongst the investor.
  - Therefore the structure of VC Fund should protect interest of investor and liquidation process should also be simple.
  - LLP, LLC are most commonly used worldwide for VC funds. eg. USA

Flexibility in Structure …………..continued

- LLP / LLC provides limited liability and pass through vehicle for tax purposes
- A separate Act should be passed. In this direction MCA has issued a concept paper on LLP for comments

Flexibility in investment

- At present VCF cannot invest more than 25% of the funds in one VCU.

➢ Flexibility in investment …………. continued

- ❖ At present VCF has to invest at least 66.67% of the investible funds in unlisted equity shares
- ❖ At present VCF cannot invest more than 33.33% of the investible funds by way of subscription to IPO or others (see reg.)
- ❖ Since VC is high risk capital and investment, it needs more flexibility in investment

Relaxation in lock in period

- At present investment of VCF in preferential allotment of equity shares of a listed company is subject to lock in period of one year

- At present there is a lock in period of one year on pre IPO shares, held by VCFs or FVCIs (for two exceptions refer slide no.25)

- Relaxation in above lock in shall be considered.

Company Law & Contractual Issues

- Memorandum & Articles of Association
  - prevails over agreements
  - should be altered accordingly

- Board Representation
- Preference Shares / Equity Shares
- Voting Rights
- ESOPS
- Intellectual Property

Company Law & Contractual Issues ….. continued

- Restrictive Agreement with Key Persons
  - Section 27 – Contract Act 1872
- Non Disclosure / Confidentiality
- Non Compete
- Anti Dilution - Full Ratchet
- Drag Along
- Tag Along
- First Right of Refusal

Company Law & Contractual Issues ….. continued

- Liquidation preferences

- Dispute Resolution
  - Courts / Litigation
  - Arbitration, India or abroad
  - Governing laws & procedure

THANK YOU

feel free to email your queries related to VC/PE/FDI at newdelhi@indiajuris.com or contact us at

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