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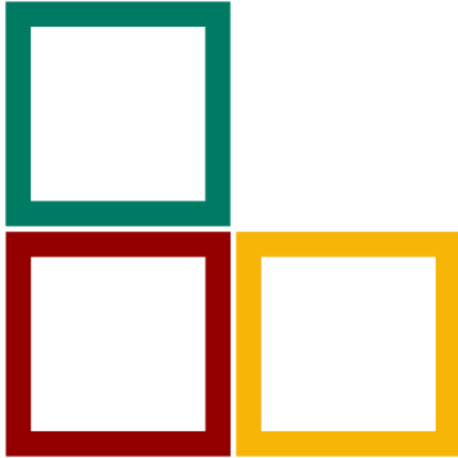

Private Equity Investments in Indian Companies

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1. PRIVATE EQUITY INVESTMENTS IN INDIAN COMPANIES – AN INTRODUCTION

As the global economy grappled with one of the largest crises till date, it is easy to understand why private equity funds the world over had ceased most of their investment activities. Now, however, that the markets are well on their way to full recovery, the role played by private equity funds and venture capital investors has once again attracted the spotlight – not only in terms of start-ups looking to mature, but also those companies that faced the ire of the economic crisis now looking to reboot their expansion plans.

It is therefore pertinent now to re-examine and refresh our minds on how private equity funds can invest into Indian companies. This article dwells on the above, as well as provides an insight into the regulatory and legal framework within which India, which is a hotspot for foreign investments, continues to liberalize its economy and open its doors wider to all foreign investors alike.

Advent of foreign investment regime in India

The economic reforms launched by the Government of India (“GoI”) from 1991 onwards have resulted in substantial economic growth and the integration of India into the global economy. While the pace of the reforms gained momentum due to political stability and strong industrial growth, the same seems to have been affected due to the aftermath of the global economic meltdown witnessed in latter half of 2007 and 2008.

That being said, undoubtedly with the opening up of the Indian capital markets to Foreign Institutional Investors in 1993, the Foreign Direct Investment ("FDI") regime too has been progressively liberalized. The significant rise in the foreign exchange reserves has further bolstered the ambition of India, Inc., and the restrictions on foreign investment have been significantly reduced. Currently, FDI is prohibited only in eight sectors (i) Retail trading (except single brand product retailing); (ii) Atomic energy; (iii) Gambling and Betting; (iv) Lottery business; (v) Chit funds; (vi) Nidhi company; (vii) Trading in Transferable Development Rights; and (viii) Any activity or sector not opened to private sector investment.

The GoI has opened up certain activities pertaining to the real estate and the agriculture sectors to the FDI regime. Now FDI in real estate is permitted in townships, housing, commercial premises, resorts, educational institutions, city and regional level infrastructure, recreational facilities and construction development projects, subject to certain guidelines. In the agricultural sector, FDI is allowed under the automatic route in activities such as floriculture, horticulture, development of seeds, animal husbandry, pisiculture, aquaculture and cultivation of vegetables etc, and tea plantations. In all other sectors, barring certain sensitive sectors such as telecom, banking, retailing, insurance, defense production, air transport and civil aviation, broadcasting, stock exchanges, commodity exchanges, insurance, etc., foreign investment up to 100% has been permitted on an automatic basis. Even in the restricted sectors, the limit for foreign investment is constantly being increased, the recent ones being exploration and mining of diamonds and precious stones, coal and lignite mining for captive consumption where the foreign investment limit has been raised to a full 100% under the automatic route. Previously the FDI limit in the banking sector had been raised from 49% to

74%. Another example of dilution of restrictions is the government's decision to allow FDI up to 51% in retail trade of 'Single Brand' products.

A summary of the economic reforms by GoI since 1991 is as follows:

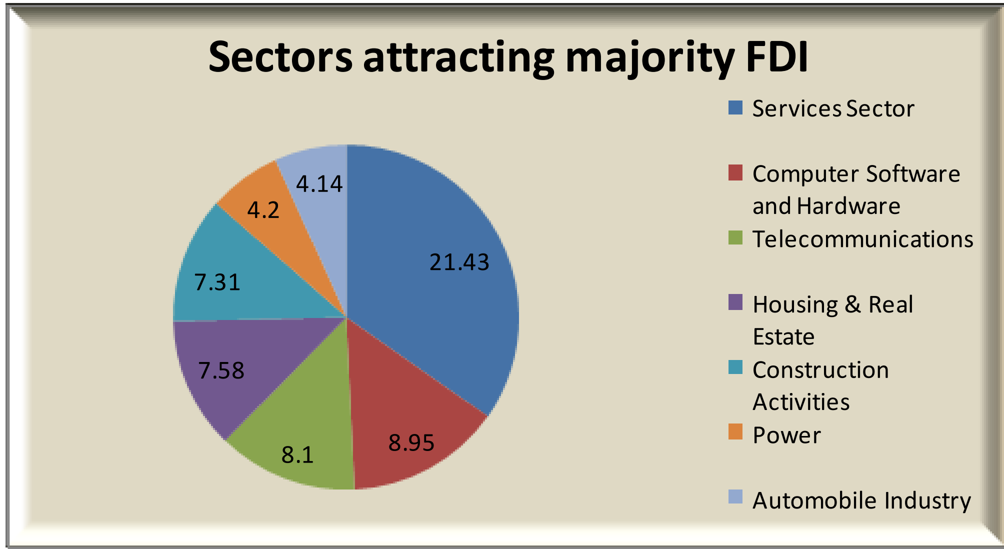
- elimination of industrial licensing requirements for majority of industries, with only areas such as health, strategic and national security issues still remaining under the ambit of licensing;
- lowering of tariff barriers and simplification of the trade regime;
- reduction or elimination of subsidies in most sectors;
- substantial liberalization of the restrictions on foreign investment, including limitations on foreign equity participation;
- increased deregulation of interest rates and introduction of more stringent standards for the financial sector;
- achievement of full convertibility of the rupee on current account;
- reduction in marginal tax rates and a simplification of tax procedures;
- dismantling of administered pricing mechanism in the petroleum sector;
- privatization of public sector undertakings; and
- several initiatives for developing the infrastructure, telecom and banking sector.

FDI inflows in the Indian economy since the liberalization of the Indian economy[1]:

FDI inflows

FDI inflows into India during the period between April 2008 to March 2009 amounted to US$ 27,309 million (US$ Twenty Seven Thousand Three Hundred and Nine Million). However the inflow of FDI reduced marginally to US$ 25,888 million (US$ Twenty Five Thousand Eight Hundred and Eighty Eight million) during April 2009-March 2010. The reason for this decrease in FDI inflows, though marginal, can be attributed to a trend which continues in the wake of the global economic crisis.

[1] RBI's Bulletin February 2007 dt: 14.02.2007 (Table No. 46 – FOREIGN INVESTMENT INFLOWS). Department of Industrial Policy and Promotion, Ministry of Commerce and Industry at http://dipp.nic.in/fdi_statistics/india_fdi_dec_2006.pdf visited on March 13, 2007.



The above chart shows the percentage break-up of sector-wise FDI inflows starting from April 2000 until March 2010[2]. Earlier, a majority of foreign investment has been into the old economy sectors like fuel, power, industrial machinery, etc. but there has been a change in this trend and the new economy sectors like services (including software services and business process outsourcing) and telecom have attracted significant amounts of investment.

In the case of Venture Capital ("**VC**") and Private Equity ("**PE**") investors, the focus had been skewed more towards high growth sectors such as Information Technology ("**IT**") until early 2001. However, with the technology slowdown following the dot-com burst, the VCs have diversified their interest into other high potential sectors such as pharmaceutical (especially biotech), manufacturing, infrastructure, banking, media and entertainment, retailing, Public Sector Undertaking (PSU) disinvestments and business process outsourcing(BPO/ (IT-enabled services).

[2] Department of Industrial Policy and Promotion, at http://dipp.nic.in/fdi_statistics/india_FDI_March2010.pdf last visited on June 23, 2010.

2. IDENTIFYING THE RIGHT OPPORTUNITIES

The first thing one needs to keep in mind while looking at PE investments in India is the fact that most companies that are not listed tend to have a relatively small capital base. Therefore, while there are tremendous investment opportunities for PE and strategic investors in India, one must allow for smaller deal sizes in comparison to the other developed markets. However, in sectors which involve extensive investment in infrastructure (like telecom, cellular and basic telephony, for example), there are huge investment opportunities even in terms of deal size. These sectors could be tapped more effectively and in a more institutional manner.

Irrespective of the size of the deal or the sector in which the investment is made, identifying the right companies for investment is a very critical matter. Investors could be looking at opportunities either for long-term capital appreciation or for investments that make sense from a strategic business perspective. Investors typically look at several aspects of a potential investee company, like business focus and strategy for the company, its financials, the management team, its ranking in the industry in India, *etc*. In the technology sectors in particular, one also needs to look more closely at the sustainability of the products or services being offered by the company and the efficacy of its business model, owing to constant threat of obsolescence.

Once an investor has identified a potential investee company, typically the same being the first step in the life-cycle of a PE deal, negotiations begin between the investor and the company on the commercial outlines of possible investment. This is a process that can sometimes last a longer period in India than in other markets owing to the presence of some large family owned businesses. Investors might possibly have to deal at this stage with the equations between the various family members who control the company and manage to get all of them on board with respect to the terms of the proposed investment, sometimes making the process delicate and long-winded. Even in cases not involving family owned businesses, the potential investee company could be one which has gone through one or more previous rounds of funding, in which case the investor may have to deal with the previous investors of the company as it would often require the consent of such prior investors for taking on more investment.

Once the commercial terms are more or less agreed upon, the investor and the company may sign a Memorandum of Understanding ("**MOU**") or Letter of Intent ("**LoI**") recording the terms agreed upon, which after due diligence, would be firmed up into a definitive agreement. There are however, several deals in India where the parties choose to skip the LoI stage and prefer to proceed directly to the due diligence process, culminating into execution of definitive transaction agreements. The legal due diligence process is very critical to determine whether the company concerned presents a good investment opportunity to the investor, and also to determine the other important aspects of the deal such as valuation of the company, the nature of representations and indemnities to be taken from the company and its founders, etc.. Moreover, given India's complex corporate, securities, exchange control and taxation laws, conducting thorough due diligence of the investee company is very crucial.

3. REGULATORY FRAMEWORK FOR FOREIGN INVESTMENT

Consolidated FDI Policy

The FDI Policy in India is formulated by the Department of Industrial Policy and Promotion ("**DIPP**"), Ministry of Commerce and Industry, GoI. In formulating the sector-specific FDI policy for various sectors, the DIPP also takes into account the guidelines issued by the other ministries of the GoI. The Secretariat of Industrial Assistance was responsible for the formulation of the New Industrial Policy of India, which was introduced in 1991, and which is amended from time to time, as and when further liberalization moves are announced by the Government.

The DIPP earlier regulated foreign investment by issuing press notes applicable to specific sectors. In an attempt to simplify the rules and regulations pertaining to the foreign direct investment ("**FDI**") policy, the DIPP issued a consolidated FDI policy ("**Consolidated FDI Policy**") on March 31, 2010. The Consolidated FDI Policy which became effective from April 1, 2010 consolidates and more importantly, subsumes, all prior press notes / press releases / clarifications issued by the DIPP as on March 31, 2010 and reflects the current policy framework on FDI.

The Indian Rupee is not fully convertible on the capital account and therefore, all transactions involving changes in the assets or liabilities of non-residents in India, or residents' assets or liabilities abroad are generally subject to special approval. While the Consolidated FDI Policy lays down the broad policy framework relating to foreign investments in India, the administration of the policy and its implementation are done through the exchange control laws. Earlier, the law which governed exchange control matters was the Foreign Exchange Regulation Act, 1973 (the "**FERA**"). This law was rather rigid and placed enormous restrictions on foreign investment. In 1999, the FERA was replaced by a more moderate law called the Foreign Exchange Management Act, 1999 ("**FEMA**"). The FEMA confers powers on the Reserve Bank of India ("**RBI**") to frame detailed regulations in respect of various aspects of exchange control in a liberalized framework[3]. Similarly, the GoI has been empowered to frame rules[4]. The RBI and the GoI have accordingly announced a series of regulations and rules respectively relating to various aspects of exchange control, including foreign investments into India. These regulations and rules supplement the Consolidated FDI Policy.

The FEMA and the regulations relating to FDI framed there under by the RBI[5] ("**FDI Regulations**") have, from time to time, on a progressive basis, been liberalizing the exchange control regime of India. The Consolidated FDI Policy is a summary of the present FDI policy and mirrors the changing environment for investment in India. Specifically speaking, Sub-regulation 4 of the FDI Regulations stipulates that an Indian entity shall not issue any security to a person resident outside India or shall not record in its books any transfer of security from or to such person unless permitted under FEMA. Sub-regulation 5 of the FDI Regulations lay down the conditions subject to which foreign

[3] See Section 47 of the FEMA.
[4] See Section 46 of the FEMA.
[5] The Foreign Exchange Management (Transfer or Issue of Security by a Person Resident Outside India) Regulations, 2000.

investors would be permitted to invest into Indian securities. For sake of analysis, the Sub-regulation 5 has been classified into its sub components in the table below.

Classification of Sub Regulation 5 of TISPRO Regulations

Sub regulation	Deals with	Applicable schedule
5(1)	Investments by foreign individuals (other than citizens of Bangladesh and Pakistan) and foreign entities	Schedule 1
5(2)	Investments by registered Foreign Institutional Investors ("FIIs")	Schedule 2
5(3)(i)	Investments by Non Resident Indians ("NRIs") under Portfolio Investment Scheme in shares and debentures of an Indian Company	Schedule 3
5(3)(ii)	Investments by NRIs other than under Portfolio Investment Scheme in shares and debentures of an Indian Company on non-repatriation basis	Schedule 4
5(4)	Investments by NRIs or registered FIIs in securities other than shares and debentures of an Indian Company	Schedule 5
5(5)	Investments by registered Foreign Venture Capital Investors	Schedule 6
5(6)	Investments by registered FIIs in exchange traded derivative contracts	-
5(7)	Investments by NRIs out of INR funds on non-repatriation basis	-

Each of the schedules to the FDI Regulations (as referred to in the above table) lays down specific conditions governing the investment by that particular category of investors. For example, FDI Scheme (that stipulates the sectoral caps) forms part of Schedule 1 to the FDI Regulations.

FDI in most sectors is now under what is known as the "automatic route", which essentially means that an investor can bring in investment in those sectors without any prior approval from any regulatory authority and the only regulatory formality includes post-facto filings with the RBI. There are certain prescribed conditions that are required to be met in order for a foreign investment to be eligible for the automatic route. Some of these significant conditions are as follows:

- The investment should be within the sectoral equity caps prescribed, where applicable. The sectoral caps are set out in Annexure B to Schedule 1 of the FDI Regulations. For example, foreign investment in the Telecom Sector was enhanced up to 74% (49% under the automatic route, FIPB approval beyond 49%) subject to the guidelines issued by the GOI[6]. Similarly, while FDI up to 100% for the IT sector and for B2B e-commerce is permissible under the automatic route, investment in B2C e-commerce is not eligible for the automatic route. Call centers is another segment where FDI up to 100% is permitted. Up to 100% equity is permitted under the automatic route for investments in the pharmaceutical sector too.

- The investment should not be in a company which is engaged in the activity or manufacture of items listed in Annexure A to Schedule I of the FDI Regulations.

- The investment should not be in a company that requires an industrial licence under Industrial Development (Regulation) Act, 1951 or under the locational policy notified *vide* Industrial Policy of 1991.

- The price at which foreign investment is made or divested is required to be in accordance with pricing guidelines specified under the FDI Regulations. These pricing guidelines have recently been revised by the RBI. . However, as will be discussed later, an exemption has been provided from this entry-pricing requirement for investments made by Foreign VC Investors registered with the Securities and Exchange Board of India ("**SEBI**")[7].

- With the exception of the IT sector, investments by multinational financial institutions in the mining sector and in all other sectors, the foreign investor cannot avail of the automatic route if such investor already has an 'existing joint venture or technology transfer/trademark agreement' in the same field in India. An 'existing joint venture or technology transfer/trademark agreement' for the above purpose is one that is existing as on January 12, 2005[8]. However, this requirement applies essentially to strategic business investors and not to financial investors who may hold other portfolio investments in Indian companies. As regards Venture Capitalist Funds which are duly registered with SEBI under the SEBI (Venture Capital Funds) Regulations, 1996, or where in the existing joint venture investment by either of the parties is less than 3% or where the existing venture/collaboration is defunct or sick, no approval need be taken.

[6] Press Note 3 (2007 Series), Department of Industrial Policy and Promotion.
[7] Vide Notification dated 26.12.2000 issued by RBI.
[8] Press Note 3 (2005 series)

- Special schemes for portfolio investment have been made with respect to investments by Foreign Institutional Investors registered with the SEBI ("**FIIs**") and for Non-Resident Indians ("**NRI**"s). Accordingly, a single FII is permitted to invest not more than 10% of the equity capital of an Indian company or 10% of the paid-up value of each series of convertible debentures issued by the Indian company. The total holdings of all FII's put together should not exceed 24% of the paid-up equity capital or paid up value of each series of convertible debentures. However, that limit may be increased by the Indian Company, up to the sectoral cap as applicable, by passing a Board Resolution followed by a Special Resolution to that effect. It may be noted that NRIs cannot register as sub – accounts of the FIIs[9].

- NRIs can, in addition to being able to invest through the normal FDI route, also make portfolio investments subject to certain conditions. A single NRI is permitted to hold up to 5% of the equity capital of an Indian company, while the total holdings by all NRIs in an Indian company cannot exceed 10%. This aggregate limit can however be scaled up to 24% by passing a Special Resolution by shareholders of the company to that effect[10]. NRIs can only do so through a branch designated by the Authorized Dealer for the purpose and duly approved by RBI. However, shares purchased by NRIs on the stock exchange under Portfolio Investment Scheme cannot be sold by way of a private arrangement to person resident in India or outside India without the prior approval of RBI[11]. Further, the pre-conditions such as minimum capitalization etc, applicable to foreign investors with respect to investment in construction and development of integrated townships, are not applicable to NRIs.[12]

- In addition to all the above, the investments should also be in compliance with all the procedural requirements of the FEMA and the FDI Regulations and the Consolidated FDI Policy as announced from time to time by the DIPP and RBI.

In cases where any of the provisions of the FDI Regulations or the Consolidated FDI Policy cannot be complied with, then such an investment transaction would require the prior approval of the Foreign Investment Promotion Board ("**FIPB**")[13]. The FIPB normally takes between 4-6 weeks to clear proposals. Transfers between two non-residents do not require any regulatory approvals from Indian Authorities[14]. Requirement of prior approval of the FIPB for secondary purchase of existing shares between resident and non-residents has been done away with, subject to fulfillment of certain reporting and other conditions.

[9] See SEBI (FIIs) (Amendment) Regulations 2008.
[10] See Schedule III of the FDI Regulations.
[11] SEBI (Foreign Institutional Investors) (Amendment) Regulations, 2008.
[12] 5.23.8, Consolidated FDI policy
[13] Regulation 10 of the FDI Regulations.
[14] *ibid.*

Venture Capital Funds

In India, both domestic and offshore venture capital funds investing in India are regulated by the SEBI. Earlier, SEBI only regulated domestic VCFs, however, in September 2000, SEBI announced a new set of guidelines enabling foreign venture capital and private equity investors to register with SEBI under the new guidelines, the SEBI (Foreign Venture Capital Investors) Regulations, 2000 ("**FVCI Regulations**"). The FVCI Regulations were substantially amended by the SEBI *vide* the SEBI (FVCI) (Amendment) Regulations, 2004.

The SEBI (Foreign Venture Capital Investor) Regulations, 2000 ("FVCI Regulations")

It is not mandatory for an offshore fund to register with SEBI as a foreign venture capital investor ("**FVCI**"). However, SEBI and the RBI have extended certain benefits to SEBI registered FVCIs some of which include:

- As per the RBI notification issued in December 2000, FVCIs shall benefit from free entry and exit pricing. Under the FEMA and the regulations issued thereunder, the entry and exit pricing of non-resident investors under the FDI route is regulated. For purchase of shares of an unlisted company, the minimum price to be paid by the non-resident investor is linked to the discounted free cash flow ("**DCF**") of the company determined by a SEBI registered category – I merchant banker or a chartered accountant. Further, if the shares of an unlisted company are being transferred by a non-resident to a resident, the price payable should not exceed the minimum price calculated for the transfer of shares from a resident to non-resident, mentioned above.

  In case of transfer of shares of a listed company (where the shares being transferred by a resident to a non-resident), then the minimum price shall be as prescribed under the SEBI (Issue of Capital and Disclosure Requirements) Regulations, 2009 ("**ICDR Regulations**") as applicable to a preferential allotment. However, for exits involving shares of listed companies, if the transfer is from a non-resident to a resident, the exit price is capped at the price which shall not be more than the price at which a preferential allotment of shares can be made under **ICDR Regulations**.

  A special exemption has been carved out for FVCIs whereby they will be exempted from both the entry and exit pricing regulations. However, though FVCIs have been conferred with the benefit of being exempt from both entry and exit pricing restrictions, this relaxation to FVCIs may have no prominence in light of the recent amendment to the income tax laws in India. Pursuant to the amendment to the income tax laws FVCIs may be liable to pay tax upon the income generated through equity investments made at a price lower than the fair market value, in a company which does not have substantial public interest. This issue is addressed in further detail subsequently below.

  The exemption from pricing guidelines was very significant benefit from the FVCIs' point of view especially when they are looking at an exit from unlisted companies through strategic sale or through buy-back arrangement with the promoters. SEBI has also exempted FVCIs from the public offer provisions with respect to transfer of shares from FVCIs to the promoters, under the Takeover Code, if the portfolio company gets listed post investment. Therefore, in cases where the Promoters are buying back the shares

from FVCIs, they will not be required to make an offer to the other shareholders of the Company, offering to buy upto 20% of the paid up capital of the company.

- FVCIs registered with SEBI have been accorded Qualified Institutional Buyer ("**QIB**") status and would accordingly be eligible to subscribe to securities at the Initial Public Offering ("**IPO**") of a VCU through the book-building route.

- FVCIs (as well as Venture Capital Funds) by virtue of being a QIB, are eligible to subscribe to the securities of Indian listed companies under the Qualified Institutional Placement route as prescribed under ICDR Regulations. Under this route, as compared to Chapter VII of the ICDR Regulations which governs preferential allotment, there is no lock-in on the securities so allotted and the time-period of conversion of issued securities which are convertible into equity shares is 60 months (i.e. 5 years) as opposed to the 18 months as prescribed for preferential allotment. Additionally, the currency of the shareholders' resolution is 1 (one) year under the QIP route as compared to the 15 days as provided in the case of preferential allotment. On the flip side, the QIP route requires the preparation of a placement document as well as mandates appointment of a merchant banker (as registered with SEBI), both of which are not the pre-requisites for a preferential allotment under the ICDR Regulations.

- Under the ICDR Regulations, the entire pre-issue share capital of a company going in for an IPO is locked for a period of one-year from the date of allotment in the public issue. However, an exemption from this requirement has been granted to domestic VC funds registered with SEBI and FVCIs, provided, the shares have been held by them for a period of at least one year as on the date of filing the draft prospectus with the Board. This would essentially allow the FVCI to exit from their investments post-listing.

Eligibility Criteria

In order to determine the eligibility of an applicant, SEBI would consider, *inter alia*, the applicant's track record, professional competence, financial soundness, experience, whether the applicant is regulated by an appropriate foreign regulatory authority or is an income tax payer or submits a certificate from its banker of it's or it's promoter's track record where the applicant is neither a regulated entity nor an income tax payer. The applicant can be a pension fund, mutual fund, investment trust, investment company, investment partnership, asset management company, endowment fund, university fund, charitable institution or any other investment vehicle incorporated and established outside India.

Investment Conditions and Restrictions

All investments to be made by a FVCI would be subject to the following conditions:

1. FVCI is permitted to invest its entire corpus in a domestic SEBI VCF.

2. At least two-thirds of the FVCI's investible funds shall be invested in unlisted equity shares or equity linked instruments of a Venture Capital Undertaking ("**VCU**"). Further, FVCIs can invest up to 33.33% by way of:

   - Subscription to IPO of a VCU whose shares are proposed to be listed;

   - Debt or debt instrument of a VCU in which the FVCI has already made an investment by way of equity;

   - Preferential allotment of equity shares of a listed company, subject to a lock-in period of one year;

   - The equity shares or equity linked instruments of a financially weak company (i.e. a company which has at the end of the previous financial year accumulated losses,
     which has resulted in erosion of more than 50% but less than 100% of its net worth as at the beginning of the previous financial year) or a sick industrial company whose shares are listed; and

   - Special Purpose Vehicles which are created by an FVCI for the purpose of facilitating or promoting investment in accordance with the FVCI Amendments.

A VCU means a domestic company whose shares are not listed on a recognized stock exchange in India and which are not engaged in activities which have been classified under the negative list which broadly includes undertakings engaged in, non-banking financial services (excluding those non-banking financial services companies which are registered with the RBI and have been categorized as equipment leasing or hire purchase companies), gold financing (excluding those companies which are engaged in gold financing for jewellery), *etc.*, and whose shares are not listed on a recognized stock exchange.

The FVCI will have to appoint a domestic custodian and will have to enter into an arrangement with a designated bank for the purpose of opening a special non-resident Indian rupee or foreign currency account. SEBI acts as a nodal agency for all necessary approvals including the permission of the RBI for opening of the bank account. In addition to the above investment conditions and restrictions, there are certain reporting and disclosure requirements that need to be satisfied by a registered FVCI on a continuing basis.

In a recent development, it has been noticed that the RBI while granting the FVCI registrations has issued letters to the domestic custodians citing that registrations shall be granted only if the proposed FVCI invests in the following 9 sectors viz. nano technology, information technology of certain qualifying forms, seed research and development, biotechnology, pharmaceutical research, production of bio-fuels,

construction and operation of certain hotel/convention centers having more than 3,000 of seating capacity, and finally, dairy and poultry industries. While a formal circular or an amendment to the FVCI Regulations to the above effect is yet to be promulgated, we understand that this is a significant step by the regulators with respect to curtailing the investment activities of FVCIs.

Certain issues on FVCI Investment:

1. *Investment in 'trusts'*

Earlier, a SEBI registered FVCI was allowed to invest in a domestic VCF registered under the SEBI (Venture Capital Fund) Regulations, 1996 without any approval being required. Accordingly, there was no distinction with respect to accepting foreign investment from an FVCI by a VCF, structured either as a company or as a trust. With the introduction of the Consolidated FDI Policy, the position seems to have changed. Currently (i.e. after the Consolidated FDI Policy):

a. An FVCI can now invest in a VCF (that is set up as a trust registered under the Indian Trust Act, 1882) only upon obtaining a prior government approval; and

b. Investment in a trust which is not registered with SEBI as a VCF is not permitted.

This change brought in by the Consolidated FDI Policy may impede a commonly used 'unified' structure by FVCIs for making investments. Further, the consolidated FDI Policy does not clarify whether the FVCIs structured as 'unified' structures, prior to coming into effect of the consolidated FDI Policy, need to obtain governmental approval, in order to continue their activities.

2. Taxation of equity investments made at less than 'fair market value'

The Ministry of Finance, GoI, has amended the Income Tax Act, 1961 ("**ITA**"), introducing Section 56 (viia), effective from June 01, 2010. Under Section 56 (viia), tax shall be levied on companies and firms which buy/receive shares for less than their fair market value. In other words, where the consideration paid is less than the fair market value of shares, the purchaser would be taxed on the difference under section 56 (viia). Public listed companies are excluded from the purview of this provision, as are transfers where the difference between fair market value and transfer price is less than INR 50,000. No exemption has been specified for FVCI entities. Therefore, although an FVCI investor may be exempt from adhering to pricing guidelines under the Indian exchange control regulations, if they make investments at less than the fair market value, they could be liable to pay tax on the difference between the fair market value and the purchase price. Fair market value is computed under the amended Income Tax Rules, 1962[15], and is in the nature of a net asset value computation for unlisted companies.

Please note that where the FVCI entity is situated in a jurisdiction such as Mauritius, this tax may not be applicable on account of tax treaty benefits.

[15] Effective from April 1, 2010

3. Buyback of shares held by FVCIs - exit option

If an FVCI receives distributions from an Indian company upon buy back of shares, such distributions may be characterized as capital gains in the hands of the FVCI entity. If the FVCI entity is situated in a jurisdiction such as Mauritius and eligible to the benefits of the India-Mauritius tax treaty, such capital gains may not be taxable.

The SEBI (Venture Capital Funds) Regulations, 1996 ("VCF Regulations")

Domestic VCFs are regulated by SEBI under the VCF Regulations. Under the VCF Regulations, a domestic VCF can be organized either in the form of a trust or as a company including a body corporate and registered under these regulations. Further, the Limited Liability Partnership Bill, 2006 has also been passed by the Parliament recently.

The corporate structure poses certain disadvantages as compared to a trust structure. Some of the significant ones being:

- Distribution of income by way of dividends can only be out of profits or retained earnings. In the event the VCF does not earn profits on an investment or has accumulated losses, it will not be able to distribute the income as dividend to its shareholders/investors. Further, a certain percentage of distributable profits have to be transferred to a general reserve thus making the distribution of entire income difficult.

- Redemption of equity is still highly regulated and can be done only out of profits or fresh issue of shares (of a different class than those being redeemed). Thus, in a loss situation it would be difficult to redeem shares.

- Even winding up of a company takes a significantly long time, anywhere between 1-3 years, making the winding up of a fund a cumbersome and long drawn process.

Investment Conditions and Restrictions

In addition to the investment restrictions and conditions applicable to FVCIs, the following conditions would apply to a VCF:

- A VCF cannot invest more than 25% of its aggregate Capital Commitments in any one VCU (defined above).
- Minimum investment to be accepted from any investor should be Indian Rupees 500,000 except in the case of employees, principal officers or directors of the VCF, employees of the manager of the VCF where lower amounts may be accepted.
- Minimum capital commitments from its investors should be Indian Rupees 50 million in any scheme launched or fund set up by a Venture Capital Fund.
- A VCF cannot invest in associate companies. 'Associate company' means a company in which a director or trustee or sponsor or settlor of the VCF or the investment manager holds either individually or collectively, equity shares in excess of 15% of its paid-up equity share capital of VCU.

Further, prior to the enactment of the Finance Act, 2007, a VCF was able to enjoy certain tax advantages so long as the VCF was registered with the Securities and Exchange Board of India and other conditions were met. A VCF, under these circumstances, was treated as a pass-through or flow-through vehicle, and thus income from its investments was not subject to a separate layer of tax at the VCF level. Under the Finance Act 2007, this special flow-through status and non-entity level tax was limited to entities making investments in non-publicly traded companies engaged in the following sectors: nano technology, information technology of certain qualifying forms, seed research and development, biotechnology, pharmaceutical research, production of bio-fuels, and construction and operation of certain hotel/convention centers having more than 3,000 of seating capacity, and finally, dairy and poultry industries. However, it continues to be possible to structure an Indian VCF in a manner that pass through treatment continues to be available, under certain other provisions of the Indian Income Tax Act, 1961.

4. STRUCTURING OF FOREIGN INVESTMENTS

India taxes the worldwide income of its residents, subject to tax treaty and other reliefs. The foreign source income of non-residents or individual persons not ordinarily resident in India is only taxed in India if the income is received in India. In certain circumstances, income arising outside India may be deemed Indian source income.

The tax system is scheduler. Taxable income is ascertained according to the rules for the particular class of income and then aggregated to determine total taxable income. Tax changes are introduced by annual Finance Acts preceded by the "Budget" statement, usually in February. The "previous year" basis of assessment is used.

The tax rates applicable for the fiscal year 2010-2011 to residents as well as non-residents in respect of the various types of income earned in India have been summarized in the table below:

Category	Status	Capital Gains				Dividend/ Withholding
		Long Term#		Short Term		Dividends declared by an Indian company are tax exempt in the hands of the shareholders and the company distributing dividends will be required to pay an additional dividend distribution tax at the rate of 15%.
		Listed	Unlisted	Listed	Unlisted	
Individual	Resident	0*/10%**	20%	15%	30%	
	Non-Resident	0*/10%**	20%	15%	30%	
Corporate	Resident	0*/10%**	20%	15%	30%	
	Non-Resident	0*/10%**	20%	15%	40%	

Long-term means where securities have been held for more than 12 months.

* Provided the transaction takes place on the stock exchange and the Securities Transaction Tax ("**STT**") has been paid.

**For transactions outside the stock exchange.

The above rates are exclusive of the currently applicable surcharge of 7.5% surcharge for Indian resident companies, 2.5% for non-residents and a 3% education cess on tax plus surcharge, payable by all taxpayers. These rates are as per the Finance Act, 2010.

All transactions entered on a recognised stock exchange in India are subject to a STT levied on the transaction value. In case of purchase / sale of equity shares and units of an equity oriented mutual fund which is settled by way of actual delivery or transfer of the equity share/ unit, STT will be levied at the rate of 0.125 % on both the buyer and seller of the equity share/ unit. For sale of equity shares and units of an equity oriented mutual fund settled otherwise than by way actual delivery or transfer of the equity share/ unit, STT will be levied at the rate of 0.025% on the seller of the equity share/ unit. Seller of derivatives would be subjected to an STT of 0.017%, where the transaction of sale is entered into in a recognized stock exchange. In case of sale of a unit of an equity oriented fund to the mutual fund, STT at the rate of 0.25% would be applicable. The STT can be set off against business income tax calculated as per the provisions of Indian tax law.

If the investor is resident in a country with which India has a Double Taxation Avoidance Agreement ("**Tax Treaty**"), the provisions of the Income Tax Act, and tax rates therein, apply only to the extent that they are more beneficial to the taxpayer.

India has developed a large network of treaties worldwide. Each of these treaties provide for different terms for taxing the income arising in India. While some treaties provide for lower withholding tax on interest, some provide for concessions on dividend withholding tax and some on capital gains. Hence, choosing a jurisdiction which provides for maximum benefit is critical.

While identifying a jurisdiction for locating the holding company, some of the important factors that one should consider are:

- Whether there is a Tax Treaty between the jurisdiction and India;
- Whether the local law provide for flexibility in terms of choice of entities;
- What are the local taxes;
- Whether the corporate laws allow enough flexibility for repatriation of capital;
- Whether there are any exchange controls which affect repatriation of income;

Depending on the nature of income and the Indian operations, various jurisdictions like Mauritius, Singapore, Cyprus, Netherlands, UAE etc. have been used as holding company jurisdictions for investing into India.

Mauritius is still considered the most favorable jurisdiction for investing into India. As per Article 13 of the India-Mauritius treaty**,** when a Mauritius resident entity transfers an Indian capital asset (such as shares of an Indian company), the gains from such a transfer are considered taxable only in Mauritius. Since Mauritius does not tax capital gains, the result is an overall beneficial position for the taxpayer. Several investors have chosen this route to make investments into India, because tax is only payable in the country of residence of the investor. The popularity of Mauritius also stems from the landmark ruling in *Azadi Bachao Andolan.* In that case, the Supreme Court of India confirmed that a Mauritius company is entitled to avail itself of treaty benefits if it was granted a tax residency certificate by the Financial Services Commission in Mauritius. The Tax Treaty with Cyprus exempts any capital gains

earned by a Cypriot entity on shares held in an Indian company from tax in India, as well as provides for the reduction of the tax payable on the interest on debentures. Therefore, it proves to be a lucrative choice for tax structuring. There has been some discussion as to the Cypriot capital gains tax exemption being discontinued. However, it is believed that the advantage with respect to deduction in tax payable on debentures may continue.

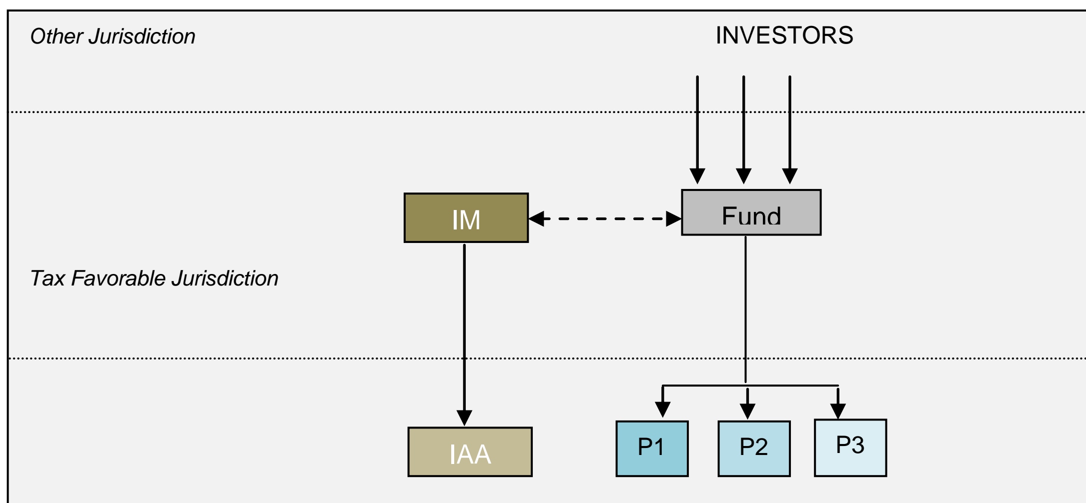
In addition to tax benefits, from an exchange control perspective, an intermediate holding company for investment into India is useful. India has exchange controls and there are restrictions on repatriation of capital. Structuring of investments through an intermediate holding company provides the necessary flexibility in terms of restructuring or divestment since all these can be carried out at the intermediary level.

Therefore, based on the above, it has become more a "rule-of-thumb" to have a Mauritius entity between the investor jurisdiction and Indian Investee Company. However a word of caution is not misplaced at this stage. It is crucial that in order to enjoy capital gains tax exemption under the Tax Treaty, one should ensure that the Mauritius entity does not have a permanent establishment ("**PE**") in India. Two common structures in relation to this are discussed below.

If the intention is to set-up a VC or private equity fund for investment into India, structuring becomes even more crucial as any additional tax on account of non-availability of Tax Treaty benefits could adversely affect the returns to the investor. The two most commonly used structures for offshore funds are as follows:

Offshore structure

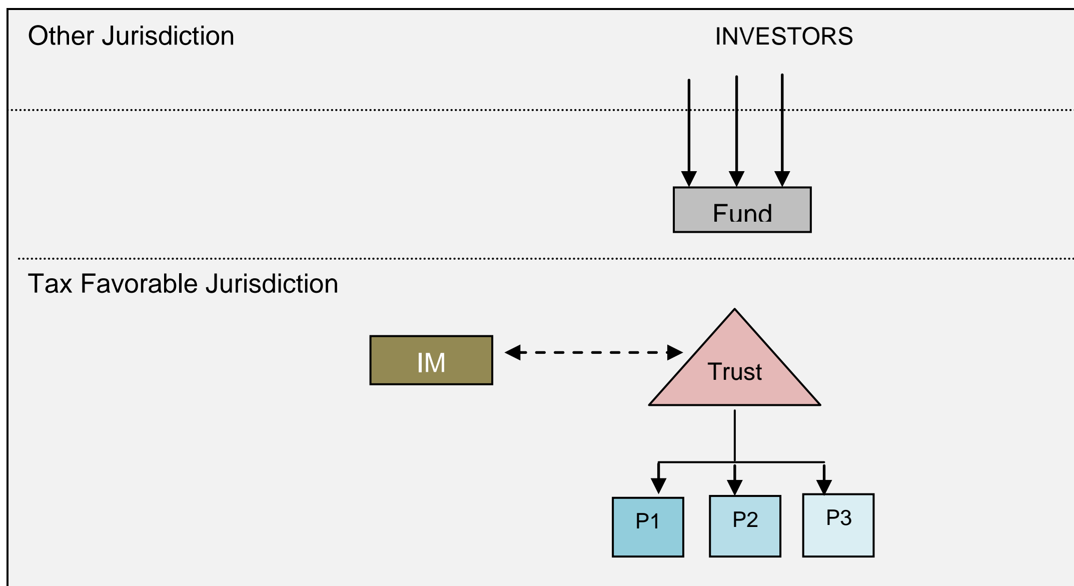
Under this structure an investment vehicle ("**Fund**"), which could be an ordinary company, an LLC or an LP organized in a tax favourable jurisdiction outside India will pool investments from investors. The Fund will then make investments directly into Indian portfolio companies or through SPVs. There would generally be an offshore investment manager ("**IM**") for managing the assets of the fund and an investment advisor ("**IAA**") in India for identifying deals and to carry out preliminary due-diligence on prospective investment opportunities. The IAA could be a 100% subsidiary of IM. As per the FDI regulations, the minimum capitalization of the IAA would have to be US$ 500,000. The structure would be as follows:



However, it is important that the Fund, the IM, the IAA and their operations are structured extremely carefully so as to minimize the risk of the Fund having a PE in India.

Unified structure

This structure is generally used where domestic (i.e., Indian) investors are expected to participate in the fund. Under this structure, a trust or a company is organized in India. The domestic investors would directly contribute to the trust whereas overseas investors pool their investments in an offshore vehicle and this offshore vehicle invests in the domestic trust. The portfolio investments are made by the trust which is registered with the Securities and Exchange Board of India ("**SEBI**") as a VC fund. The trust would generally have a domestic manager or an adviser. The offshore fund may also have its own offshore manager/adviser. This structure also enables the domestic manager to draw its share of carry directly from the trust. The structure is depicted in figure 2.



Another variant to the above alternative could be where the Fund, instead of investing through the domestic trust, can invest in parallel to the trust.

In order to structure a fund through Mauritius (under both the above options) and in order to be eligible to avail the benefits under the India-Mauritius Tax Treaty, careful structuring is extremely crucial. There have been instances in the past where the use of Mauritius as a conduit for investing into India has been looked upon unfavorably by the Indian tax authorities. In the case of NatWest Bank PLC, the Authority for Advance Rulings ("**AAR**") had denied a ruling on the grounds that use of Mauritius was merely for tax avoidance and the AAR need not rule on the application. It also observed that in cases where the use of Mauritius is *prima facie* for avoidance of tax, the benefits of Tax Treaty should not be available to the Mauritius entity. However, careful structuring of an investment can reduce the risk of denial of Tax Treaty benefits. There has been a ruling in case of AIG, followed by DLJ, wherein the AAR granted the benefits of India-Mauritius Tax Treaty and observed that if there was a commercial justification for setting up a Special Purpose Vehicle ("**SPV**") and then if the same was established in Mauritius, that *per se* should

not result in denial of a ruling and benefits under the India-Mauritius Tax Treaty. In fact, the Supreme Court of India, which is the apex court in India, has reaffirmed the availability of the India-Mauritius Tax Treaty benefits to offshore investors investing into India through Mauritius, in cases such as *Azadi Bachao Andolan*. The Supreme Court ruled that in the absence of an anti-treaty shopping provision in the India-Mauritius Tax Treaty, the benefits of the tax treaty could not be denied so long as the Mauritius entity is a resident of Mauritius.

On the other hand, there is a recent trend in which lower level tax authorities have begun to take an aggressive stand and have started looking at Mauritius-based structures more closely. Recently, in the case of *E*Trade Mauritius Limited*, the tax authorities disregarded the existence of an intermediate shareholding company in Mauritius, and applied the provisions of the India-U.S. tax treaty even though investments were made by the Mauritian entity.[16] In another case involving Vodafone, the existence of the Mauritius subsidiary was looked through entirely. The High Court heard the matter of Vodafone and refused to quash the notice on the grounds that the tax authorities had a prima facie case. The taxpayers appealed in a special leave petition to the Supreme Court of India, which held that the tax authorities can determine the preliminary question of jurisdiction and that Vodafone can question the decision of the tax authorities before the High Court. The case is currently being heard at the lower administrative (ADIT) level by the revenue authorities.

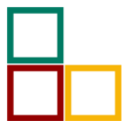
By provisioning for the worst-case scenario, and in light of the subsequent notices that have been issued to the parties who have entered into Vodafone-like transactions, it is pertinent that due attention be paid to such issues at the time of structuring of the investments. In any case, the Vodafone matter is all set to create a precedent – whether in favour of the tax authorities, or not.

In addition to the commercial justification, it is also important to ensure that the structure does not expose the Fund to a permanent establishment (“**PE**”) in India. Under the India-Mauritius Tax Treaty, if the Fund were held to have a PE in India, the income attributable to such PE would be subject to tax in India. So as not to constitute a permanent establishment status, all investment decisions must be taken and effective management must be carried out, outside India. In Morgan Stanley DIT, the AAR had held that the outsourcing activity by the US Company to its subsidiary would not constitute the subsidiary as a permanent establishment of the parent company. In February 2007, this view was upheld by the Supreme Court, which held that the mere enterprise relationship between the subsidiary and the parent would also not lead to the conclusion that the parent had a permanent establishment in India. There is a fair amount of subjectivity involved in the determination of a PE and hence very careful thought has to be given while finalizing the structure, especially the management of the Fund from India.

In one of the recent rulings, the AAR has held that the income earned by a private equity fund should be treated as business income and not as capital gains, since the private equity fund is in the business of making investment. However, so long as the investor does not have a PE in India, it should not be subjected to tax in India. This ruling essentially means that even if the fund was not established in Mauritius but in any other country having a Tax Treaty with India - provided the fund does not have a PE or a business connection in India - the income earned by the fund should not be subjected to tax in India.

[16] A ruling by the Authority for Advance Rulings subsequently ruled in favour of the taxpayer in this case.

Therefore, appropriate structuring continues to be of vital importance, and investors should keep these issues in mind. It is also important to note that the Indian Direct Taxes Code is currently under discussion and is proposed to be made effective from April 1, 2011. The first draft bill was introduced in 2009 and came under significant criticism for the controversial and sweeping nature of reforms proposed. An amended draft has been introduced in June 2010, which is currently under discussion. Depending on the final form of the enacted legislation, investors may need to be prepared for amendments to the present system such as a general anti-avoidance rule and a change in rules of residence of a foreign entity.



5. STRUCTURING THE INSTRUMENT

Having gone through the initial stages of due diligence and negotiations, and after having addressed the entry level exchange control issues, the next concern an investor is likely to look at is what kind of instrument it should get against its investment, and what level of protections and risks the investor should bear in mind with respect to these investments. While this may be more relevant in a private equity context, it could be equally relevant in certain strategic investments.

The simplest and perhaps the most obvious instrument that an investor can get to evidence would be the equity share. However, for several reasons, an investor may wish to hold a part or whole of its investment in the form of some other instrument.

Some of the usual reasons in an Indian context why a foreign investor would prefer an instrument other than equity shares are outlined below:

- The investor may wish to get a preference on dividend or liquidation or both.
- As discussed earlier, prevailing Indian exchange control laws do not permit foreign equity investment beyond a certain level in certain sectors. Therefore, the investor might want to structure an instrument which does not violate Indian exchange control laws. However this roadblock seems to be gradually easing as the GoI has been constantly increasing the limit of FDI in most sectors such as the telecom sector as already mentioned above.
- The investor may wish to get disproportionate voting rights on its investment in return for the strategic value such investor may bring to the table.
- Indian corporate and securities laws may place certain restrictions with respect to equity shares which may not suit the commercial understanding between the parties.
- The investor may seek liquidity in overseas markets and the maximum flexibility in terms of exit options.

Given the above reasons, the following alternate instruments are usually resorted to by investors in Indian companies who face any of the above problems. Understandably, the instrument chosen is based on those considerations that matter most to the investor and therefore, the transaction has to be viewed overall before determining which alternate instrument best suits the needs of an investor.

<u>Instruments Denominated in Indian Rupees</u>

- *Convertible Preference Shares* – Under Indian company law, a preference share by definition gets a preference over the other shareholders as to dividends and recovery of capital in the event of liquidation. A convertible preference share is a preference share that is converted to equity shares based on a specified conversion ratio upon maturity. Till the time of conversion, the shareholder would continue to receive dividends at a specified rate. However, a convertible preference share will carry no voting rights till the time of

conversion, except in very limited circumstances. It must be noted that this would not address the difficulties that exchange control sectoral caps may place, as fully convertible preference shares are treated the same as equity shares for the purpose of reckoning sectoral investment caps. With effect from 1 May, 2007 only preference shares which are fully and mandatorily convertible are eligible to be issued to persons resident outside India under the FDI scheme[17]. Further, the RBI has prescribed that the dividend payable on convertible preference shares issued to non-resident parties cannot be in excess of 300 basis points over the Prime Lending Rate ("**PLR**") of the State Bank of India on an annual basis.

- *Convertible Debentures* – Debentures are basically debt instruments. In the case of a convertible debenture, the debenture holder would receive interest from the company till the maturity date, after which the debentures would be converted into equity shares ranking on par with the other equity shares of the company. Convertible debentures too are treated the same as equity shares for the purpose of reckoning sectoral caps, and this instrument would therefore not be very helpful in the event of difficulties posed by sectoral caps. In this context, the RBI, though its circular[18] dated June 08, 2007, has clarified that only instruments which are fully and mandatorily convertible into equity, within a specified time would be reckoned as part of equity under the foreign direct investment policy and eligible to be issued to persons resident outside India under the Foreign Direct Investment Scheme. Therefore, optionally or partly convertible or non-convertible debentures will be regarded as debt and a foreign investor will require prior approval from the FIPB and the RBI prior to investing through such optionally convertible or non-convertible instruments. Further, subscription to such optionally or partially convertible debentures will require compliance with the guidelines for external commercial borrowings which impose several restrictions on end-use, all-cost ceilings, eligible lenders and borrowers etc. As far as the rate of interest on the debentures issued to non-residents is concerned, the FDI Regulations are silent on this aspect. However, by drawing an analogy with the payment of dividend on preference shares as discussed above, a view could be taken that the maximum permissible rate of interest that could be paid on the debentures as issued to non-residents on an annual basis is 300 basis points over the PLR of the State Bank of India.

- *Warrants* – These are basically convertible instruments that can be converted into equity shares at the convenience of the holder, by paying a conversion price. A warrant is basically a right to subscribe to equity shares at a later stage. Earlier (i.e. prior to the coming into effect of the consolidated FDI Policy), the FDI policy was silent on the issuance of convertible warrants / partly paid-up shares by Indian companies to foreign investors; it only contemplated issuances of shares and debentures. In the absence of legislative guidance, investors and issuers sought the approval of the FIPB for issuances of warrants and partly paid up shares, and the FIPB granted it on a discretionary, conditional and case-specific basis.
  However, after the coming into effect of the consolidated FDI Policy, there appears to be a complete bar on the issuance of warrants. The reason being, the definition of 'capital' under the consolidated FDI Policy carries a note which states that "Any other type of instruments like warrants, partly paid shares etc are not considered as capital and cannot be issued to persons resident outside India".

[17] See RBI/2006-2007/434 A.P. (DIR Series) Circular No. 73 , 8 June, 2007.
[18] RBI/2006-2007/435 A.P. (DIR Series) Circular Number 74.

Therefore, in light of the above definition of 'capital' it may not be incorrect to conclude that the consolidated FDI Policy prohibits the issuance of warrants to non-resident, completely.

Instruments Denominated in Foreign Currency

The reason a foreign investor would wish to receive an instrument denominated in foreign currency is to get liquidity in an international market. Therefore, apart from being denominated in an internationally accepted currency, the instrument also has to be a universally recognized one. The two most commonly recognized foreign currency denominated securities that can be issued by Indian companies are Global Depository Receipts ("GDR"s) / American Depository Receipts ("ADR"s) and Foreign Currency Convertible Bonds ("FCCB"s).

- *ADRs/GDRs* – They are treated as foreign securities issued by an Indian company and these instruments are founded on underlying equity shares. The underlying shares are denominated in Indian Rupees while the ADRs and GDRs are usually denominated in dollars. Foreign investors in Indian companies who seek to have their investment evidenced by a dollar denominated instrument can therefore, seek to have ADRs/GDRs issued to them by the company by way of a private placement. This would mean that they would hold ADRs/GDRs that are not registered with the regulators or stock exchanges outside India. The holders of ADRs/GDRs can sell these instruments privately outside India or they could convert these instruments into the underlying equity shares at any point of time. In the event that the Indian company subsequently goes in for a publicly listed ADR/GDR offering in the US or such other market outside India, then the investor could seek concurrent registration of the ADRs/GDRs held by it. This right would typically be provided upfront in the investment transaction documentation. The regulatory regime in connection with ADRs and GDRs is discussed later in this paper.

- *FCCBs* – These are basically considered as external commercial borrowings of the Indian company. They provide for an interest return to the investor for a specified maturity period at the end of which they can be converted into equity shares of the issuing company. FCCBs would, in principle, provide essentially the same kind of comfort to the investor, *i.e.*, liquidity in international markets. However, it may be mentioned that FCCBs are not as popular or commonly accepted internationally as are ADRs and GDRs. This is one reason why companies seeking to raise money through equity expansion prefer the ADR/GDR route to the FCCB route. The regulatory regime for issue of FCCBs is mentioned in the next section.

6. REGULATORY REGIME FOR ISSUE OF ADR/GDR AND FCCBs

As mentioned earlier, the issue of ADRs/GDRs or FCCBs by Indian companies is governed by:

(i) the Issue of Foreign Currency Convertible Bonds and Ordinary Shares (Through Depository Mechanism) Scheme, 1993 ("**Scheme**");
(ii) the various guidelines issued by the Ministry of Finance ("MOF") in addition to the Scheme; and
(iii) The various notifications and regulations issued by the RBI vide its powers under the FEMA.

The policy in this regard is formulated by the Ministry of Finance and this policy is given effect to by the RBI through the FDI Regulations. Accordingly, the following are important aspects of the prevailing law governing the issue of ADRs/GDRs or FCCBs by Indian companies:

- Indian companies may issue ADRs/GDRs without the prior approval of the regulatory authorities, provided the total foreign equity in the company, inclusive of the ADRs/GDRs to be issued, does not exceed the sectoral caps, if any[19].

- Track record requirements in connection with eligibility to issue ADRs/GDRs which existed earlier were done away with in January, 2000.

- Indian company which is not eligible to raise funds from the Indian capital market or which has been restrained from accessing the securities market by SEBI is not eligible to issue FCCBs, ADRs/GDRs.

- Unlisted Indian companies issuing such instruments require to simultaneously list in the Indian Stock Exchange. However, the unlisted companies that have taken verifiable "effective steps" before the 31st of August 2005 would be exempt from the requirement of prior or simultaneous listing provided they complete their issues latest by 31st December, 2005.

- An Indian company may, in the normal course, issue ADRs/GDRs only against an expansion of the capital base by issue of fresh underlying equity shares. However, as a result of recent amendments to this policy, listed Indian companies have now been permitted to sponsor ADR/GDR issues against the shares held by the existing shareholders of the company, subject to certain specified conditions. Similarly, a company which already has its ADRs/GDRs listed on any recognized stock exchange outside India can now issue ADRs/GDRs against existing shares to the extent that its ADRs/GDRs have been converted into equity shares.

[19] Circular No 15/99, Ministry of Finance, Department of Economic Affairs dated 19th January 2000

- The issue of the ADRs/GDRs has to be in full compliance with the various requirements under the FDI Regulations, including the minimum pricing restrictions, the FDI Policy as announced from time to time by the SIA and the guidelines issued from time to time by the Ministry of Finance pursuant to the Scheme.

- Indian companies are also permitted to issue ADRs/GDRs by way of private placement, provided they appoint an investment bank registered with SEC or such other regulator to lead manage the issue.

- Issues of FCCBs were earlier not within the scope of the automatic route and required the prior approval of the Ministry of Finance. Now, FCCBs have been brought within the automatic route with a maximum limit of up to US$ 500 million in one financial year, beyond which approval of the RBI would be required. Further, there are certain conditions prescribed by the RBI in connection with issue of FCCBs, which need to be complied with. The most important of these conditions are (i) the FCCBs, together with foreign equity already held in a company cannot exceed the sectoral caps, if any; and (ii) the FCCBs shall have a minimum maturity period of 5 years[20].

[20] Foreign Exchange Management (Transfer or Issue of any Foreign Security) Regulations, 2004.

7. DOWNSIDE PROTECTIONS

Once an investor has decided to go ahead with an investment opportunity after the due diligence process, the transaction typically enters the documentation stage. At this stage, one of the most important considerations investors typically look for is to put adequate downside protections in place in the documentation with respect to its investment in the company. This may require some level of planning in addition to other factors influencing the investor's choice of the instrument it would like to receive in respect of its investment. While investors from the US, UK, etc. are more familiar and conversant with certain mechanisms for providing these downside protections, some of these mechanisms may not work in India and may have to be either modified to suit Indian laws or replaced with alternate mechanisms that would work in the Indian legal system.

In most cases, particularly in private equity investments, the investor seeks to ensure a downside protection against dilution by way of a ratchet mechanism. The basic principle on which the ratchet mechanism operates is that whenever the company issues additional shares to a third party at a price that is lower than the investor's entry price, then such investor would get issued such number of additional shares at no cost to ensure anti-dilution of the investor at no additional cost. While this is a fairly accepted term in virtually all private equity investments, Indian law poses certain practical difficulties in giving effect to this kind of a ratchet mechanism.

Indian company law requires that no shares can be issued by a company at a discount to par value[21]. Therefore, it is not possible to issue shares at no cost to any shareholder as envisaged in the ratchet mechanism. One has to find indirect and often complicated means of funding the ratchet. Although these kinds of transactions have not been too numerous in India, the mechanisms which can be used to give effect to the ratchet given the constraints under Indian law are:

- *Bonus Issue* - In this mechanism, the ratchet would be funded by a bonus issue by the company. The other shareholders of the company would agree to waive their rights to the bonus shares and only the investor would get the additional shares at no cost. The documentation would upfront provide for this mechanism and would contain covenants from the company and the other shareholders to the effect that they would take all actions legally necessary to give effect to such a bonus issue. However, this is NOT a tried and tested mechanism and has its own risks associated with it. Firstly, it is a contentious issue as to whether a shareholder can waive his bonus entitlement, and no clear law or precedent exists on the point. Further, the issue of bonus shares is not eligible for automatic approval and as such, would require the approval of the RBI. The RBI may have reservations about approving such an arrangement. Thirdly, under Indian company law, a bonus issue can be funded only out of distributable profits of the company or from the securities premium account[22]. Therefore, if a company does not have sufficient distributable profits, then this mechanism would not provide adequate protection to the investor.

[21] Section 79 of the Companies Act, 1956.
[22] See Sections 205 and 78 of the Companies Act, 1956.

- *Issuance at Least Legally Permissible Price*[23]- This mechanism takes into account the restrictions under Indian law on issuance of shares and tries to mitigate the effect of a downround issuance of shares to a third party by enjoining on the company to issue such number of additional shares to the investor on a preferential allotment basis at the "least legally permissible price" as to ensure the investor's anti-dilution. In India, a non-resident party cannot be issued shares at a price that is lower than the price arrived at on the basis of a formula prescribed by the RBI. Therefore, the Indian company would have to issue shares at the least permissible price. While this method is legally sound and risk-free in terms of enforceability, it might not offer adequate protection to the investor. For instance, an Indian party can be issued shares in a company at any price that is higher than the par value. If the company's shares have a high value calculated in accordance with the DCF method,, then the investor may not be able to get a sufficient number of additional shares to get any kind of meaningful protection against a situation where an Indian party has been shares at par value. This issue assumes a greater significance in the event of the investor holding less than 25% of the voting rights of the company, in which case the other shareholders would be able to approve such an issuance to a third party on their own, to the prejudice of the investor.

- However, in case of FVCIs registered with SEBI, the RBI has made a special exemption from the entry pricing norms[24] and therefore, FVCIs too can be allotted shares at a price that is not lower than par value.

- Further, according to the Consolidated FDI Policy, issuance of compulsorily and mandatorily convertible debentures and fully, compulsorily and mandatorily convertible preference shares are subject to minimum pricing requirements as discussed above. The pricing of such capital instruments should be decided / determined upfront at the time of issuance of the instruments. This implies that the conversion ratios and the price of the shares to be issued pursuant to the conversion of the convertible instruments will have to be fixed upfront at the time of issuance of the convertible instruments.

- *Veto on Future Issuances* - Another way to ensure a downside protection for the investor is to provide for a veto power for the investor on all future issuances of the company. This mechanism would be very useful where the investor holds less than 25% of the voting rights in the company[25]. However, from a business point of view, this clause may create a bit of a problem, as it may impose a restriction on the ability of the company to raise capital when it needs capital. It would put the investor in a position where the investor may be compromising the interests of the company in order to protect its own interest in the company. Therefore, this veto power may be used as a last resort downside protection and typically, is provided for in addition to the other mechanisms detailed above.

Therefore, the best approach from point of view of documentation in order to provide for effective downside protections to the investor is to provide for a combination of all the three mechanisms mentioned above, with each mechanism getting operational in the event of the prior one failing to provide sufficient protection to the investor.

[23] For listed companies, the minimum price is calculated on the basis of average highs and lows over a certain period. For unlisted companies, this price is computed on the basis of DCF method..
[24] See *supra* n.5.
[25] Most important corporate matters require to be passed by way of special resolution. A special resolution requires at least 75% of the shareholders present and voting to approve the resolution.

8. EXIT OPTIONS

At the time when an investor makes an investment into a company in India, it is also thinking about the exit options open to it under Indian laws. Exit strategy is a very critical part of making investments, not only for private equity players but even for strategic business investors. It is often extremely critical for an investor to be able to divest its holdings and exit in the most profitable and expeditious manner. Further, given the constant changes in the business environment, the investor's exit strategy may have to be adaptable and flexible to change. Investors would therefore have to adopt an investment structure that would afford them maximum flexibility in their exit strategy and the most number of exit options.

The following are, broadly speaking, the most common exit options available to offshore private equity and strategic investors:

- *IPO in India* - If the Indian markets look promising, which currently are experiencing a slump, and the investor feels comfortable that an exit in the Indian stock markets would give it a good exit opportunity, then the investor could exit after an IPO. It must be noted however, that as per the DIP Guidelines, all pre-IPO share capital of a company would be locked-in for a period of one year after the completion of the IPO. An exception has been carved out in this regard for VCFs/FVCIs registered with the SEBI provided that they have held these shares for at least one year prior to the IPO. Therefore, offshore funds, which are registered with the SEBI as FVCIs would be entitled to this exception (provided that they have held these shares for at least one year prior to the IPO) and can divest their holdings immediately after an IPO.

- *ADR/GDR Listing* – The investor could also, if it held its investment in the form of ADRs/GDRs as explained earlier, exit at the time of an ADR/GDR issue by the company in an overseas market. The investor would, pursuant to its registration rights under the investment transaction documents, be entitled to concurrent registration of the ADRs/GDRs held by it along with the public issue and would therefore, get tradability in the overseas markets. Alternatively, even if the investor held its investment in the company in the form of equity shares, it could exit by way of a sponsored ADR/GDR program once the company gets listed. This would provide the investor the opportunity to exit in an overseas market at the time of an ADR/GDR issue by the company.

- *Strategic Sale* – The investor could also exit by way of a strategic sale of its holding in the company to another party who may wish to buy that stake for strategic reasons. If the transferee is an Indian resident, then as per the FDI Regulations notified by the RBI, if the investee company is listed at the time of exit, then the investor cannot exit at a price that is higher than the price at which a preferential allotment of shares can be made under ICDR Regulations[26]. In case the Indian company is unlisted at the time of such exit through a strategic

[26] See *supra* n.5.

sale, the price payable should not exceed the minimum price calculated for the transfer of shares from a resident to non-resident, by a SEBI registered category-I merchant banker or a chartered accountant as per DCF method. .[27]. This exit pricing restriction can place a huge fetter on the ability of non-resident investors to charge a high premium to sell their stakes to parties who are interested in acquiring the same for reasons of high strategic importance. However, the RBI has carved out a specific exemption from this exit pricing restriction for FVCIs registered with SEBI and such entities can exit at a mutually agreed price. Further, if the strategic buyer happens to be another non-resident party, then again, the exit pricing restrictions of the RBI will not be applicable.

- *Buyback / Put Options* – As the window of redeeming securities held by a foreign player in an Indian company has been closed (as any security that is not compulsorily convertible into equity is classified as an 'External Commercial Borrowing' for exchange control purposes), alternate exit rights such as a 'buyback' right against the company or a 'put option' to the promoter (subject to the promoter's liquidity) may be sought. Under Indian company law, there are certain restrictions and conditions that would have to be complied with for any buyback of securities by a company (e.g., (a) buyback cannot exceed 25% of the free reserves and paid-up capital of the company, (b) buyback offer to be made to all shareholders, buyback of shares should be authorized by the company's articles etc).

[27] *ibid.*

9. CONCLUSION

Despite the regulated environment, India continues to be a hotspot for foreign investment. It offers great investment opportunities not only in the traditionally lucrative service sectors and sectors such as manufacturing, banking, information technology and others, but also in infrastructure, pharmaceuticals, telecom and media and entertainment which are likely to further attract significant amounts of investment. As the Indian emerging economy speedily grows, it is hoped that the regulators continue to liberalize the economy and offer incentives to boost foreign investment.

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