World Law Group

October 8th – 9 am EDT Teleconference Agenda

https://global.gotomeeting.com/join/762606757

1. Welcome and Introductions – Allan Goodman, Srinath Dasari, Jens Wolf

2. Proposed Initiatives

    a. Venture Capital Guide (see attached draft)
    b. Quarterly eBulletins

3. Topic for Discussion: model investment documentations such as NVCA (U.S.A.), BVCA (UK).

4. Jurisdictional Updates: members share what is happening in their jurisdictions

5. WLG Happenings

6. Other Business

THE WLG VENTURE CAPITAL GUIDEBOOK 2019 | INDIA

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Geography : India

1. **In your jurisdiction, which sectors do venture capital funds typically invest in?**

Key sectors attracting venture capital (**VC**) investments in India include information technology, e-commerce, healthcare, consumer, financial services (including mobile wallets and digital payment solutions), education and hospitality.

[**AZB**: *Should any statistics be included on deal value and volume? We can plug in information for 2018 and H1 of 2019.*]

2. **Are there any sectors in which investment is prohibited or which are significantly regulated in your jurisdiction?**

Foreign investment in India is generally permitted in most business sectors, subject to compliance with prescribed entry routes, pricing guidelines and, in certain cases, foreign investment caps and performance-linked conditions. Although there are certain sectors in which foreign investment is banned (such as atomic energy, railway operations, lottery, gambling and betting activities, certain forms of real estate and allied businesses, and the manufacture of tobacco products), these are generally not of particular relevance to VC investors.

Broadly, there are three entry routes available for investments by a foreign VC in India: **(a)** foreign direct investment (**FDI**); **(b)** as a foreign venture capital investor (**FVCI**); and **(c)** as a foreign portfolio investor (**FPI**). The regulatory framework for foreign investment (including permitted sectors for investment, investment caps, pricing regulations, and permitted capital instruments) vary depending on the investment route. Each of these routes is discussed briefly below.

FDI

Investment in equity and equity-linked instruments by non-residents in, **(a)** an unlisted Indian company, or **(b)** 10% or more of the post issue, paid-up equity capital of a listed Indian company, is categorised as FDI. Permitted capital instruments for FDI transactions are equity shares, fully and compulsorily convertible debentures, fully and compulsorily convertible preference shares, and share warrants.

As a key requirement, at the time of investing in unlisted securities, foreign investors are required to acquire equity and equity-linked instruments at a price which is not lower than the fair market value of the instrument. This condition is not applicable, where a non-resident sets up the Indian company and is its first shareholder, and in case of transfers between non-residents.

Where instruments are transferred from a non-resident to an Indian resident, the price per share cannot be higher than fair value, where as a transfer from a resident to a non-resident should not be at a price which is less than fair value. Similar pricing restrictions are applicable on subscription, acquisition and transfer of listed securities as well.

Investment through FDI is permitted either under the 'automatic route' (which does not require prior regulatory approval) or under the 'government approval' route, both with or without attendant conditions. To illustrate, the information technology and manufacturing sectors are allowed to receive FDI up to 100% without any sector-specific regulatory conditions. E-commerce, wholesale trading and financial services, although permitted to receive FDI of up to 100%, are subject to investment caps and sectoral conditionalities. Apart from this, there also sectors such as multi brand retail trading and print media, where FDI is permitted only with prior government approval, are subject to sector specific conditions and to a ceiling limit on foreign investment.

From a VC standpoint, insurance, financial services and retail trading are sectors that are subject to significant regulatory oversight.

FVCI

Foreign VCs can also make investments under the FVCI route after registering with the Securities Exchange Board of India (**SEBI**). An FVCI can invest in unlisted securities of ten specified sectors, including biotechnology, information technology related to hardware and software development, nanotechnology, seed research and development, production of bio fuels and the infrastructure sector.

FVCIs can also invest in equity and equity-linked instruments issued by a 'startup' company (regardless of the sector in which the startup is engaged), as well as in convertible notes. A private company registered in India will be considered a 'startup' for a period of five years from its incorporation, if its turnover in any financial year has not exceeded [INR 250 million] and the company is working towards innovation, development, deployment or commercialisation of new products, processes or services driven by technology or intellectual property. A key advantage of investing through the FVCI route is that Indian exchange control regulations allow startups to issue convertible notes to FVCIs. A convertible note is essentially evidence of money received by the startup as debt, which is repayable at the option of the holder or convertible into equity shares of the startup (subject to terms and conditions mentioned in the instrument), within a period of not more than five years from its issuance. Subscribing to convertible notes is not permitted under FDI.

Further, FVCIs can also invest in units of domestic venture capital funds or category I alternative investment funds and in securities listed on a recognised stock exchange in India, subject to the Securities Exchange Board of India (Foreign Venture Capital Investors) Regulations, 2000 (**FVCI Regulations**).

One of the key conditions imposed on FVCIs by SEBI is to ensure that: **(i)** at least 66.67% of its investible funds are in unlisted equity shares or equity linked instruments of domestic venture capital undertakings; and **(ii)** not more than 33.33% of funds are invested in, among other things, subscription to an IPO of a domestic venture capital undertaking and debt or debt instruments of a venture capital undertaking in which the FVCI has pre-existing equity investments.

There are several advantages to a foreign VC being set up an FVCI as compared to investing through the FDI route. By registering as an FVCI and being subject to regulatory oversight, a foreign VC can acquire, purchase and sell instruments at a mutually agreed price, and need not comply with minimum pricing guidelines as in the case of FDI. FVCIs are also exempt from minimum lock in requirements prescribed under the regulations governing public listing of securities (provided the FVCI held such securities for a minimum period of one year prior to listing).

FPI

In addition to the FDI and FVCI routes, investment by FPIs is also permitted in India, subject to obtaining registration. Briefly, each FPI is permitted to invest in listed and to be listed securities up to a less than 10%. As these investments are generally limited to minority non-strategic investments by portfolio investors and are not sector specific, we have not examined this route in greater detail for VCs.

3. **Do venture capital funds require any approvals before investing in your jurisdiction?**

FVCIs are required to obtain a one-time registration under the FVCI Regulations with the Securities Exchange Board of India (**SEBI**). Investments under the FDI route do not require any registration, but may require prior government approval depending on the sector in which the investment is being made.

4. **Are there any legal limitations to an offshore venture capital fund acquiring control or influencing the business, operations or governance of an investee entity?**

There are no restrictions on a foreign VC acquiring control or influencing operations of a private company.

In case of a listed target, however, a first-time investor (together with persons acting in concert) cannot acquire 25% or more of the voting rights or control unless it makes a mandatory tender offer to acquire an additional 26% of the capital from public shareholders of the target. A mandatory tender offer requirement is also triggered where an investor holding 25% or more voting interest, seeks to acquire control, or additional shares or voting rights exceeding 5% in a financial year.

5. **Would an investor be required to undertake an anti-trust analysis prior to investment? When would such a requirement be triggered?**

Generally, early stage VC transactions in India rely on a statutory exemption from mandatory pre-merger notification requirements under the merger control regime. Currently, merger control regulations allow for an exemption from notification where the target either has assets not exceeding INR 3.5 billion *(approx. USD 54.17 million)* in India, or has a turnover not exceeding INR 10 billion *(approx. USD 154.77 million)* in India. This exemption is currently available until March 29, 2022.

6. **Are there any proposed regulatory changes impacting venture capital transactions in your jurisdiction?**

Easing of FDI regulations

Although FDI in manufacturing is currently allowed up to 100%, there is no specific provision which allows contract manufacturing. In a recent announcement, the government has clarified that FDI will be permitted in contract manufacturing up to 100%. This will allow electronic companies (such as Apple) and pharmaceutical firms to outsource the manufacturing process and directly invest in local third party manufacturers.

In addition to this, the government also relaxed the local sourcing requirements applicable to single brand retail trading companies having FDI beyond 51%. Presently, companies engaged in single brand retail trading are required to locally source at least 30% of the value of their goods from India. The government has now allowed such entities to take into account all procurements made form India towards its local sourcing requirement, regardless of whether they are exported or sold in India. Further, single brand retail trading establishments can now start online retailing without having to first establish a physical store (a mandatory requirement as per the prevailing policy). The physical store can now be opened within a period of two years from commencing online retail.

Additional conditions for investment

The e-commerce sector is permitted to receive FDI up to 100%, provided the business is run as a marketplace (and not an inventory) based model, without exercising any control or ownership over the inventory. An inventory based model of e-commerce expressly barred under the FDI policy.

Towards the close of 2018, the government issued certain additional conditions on the e-commerce sector such as, disallowing an entity having equity participation in an e-commerce marketplace or its group companies or having control on its inventory by e-commerce marketplace entity or its group companies, from selling its products on the platform run by such marketplace entity. Further, to ensure that the e-commerce platform does not have control or ownership over inventory, it is now essential to ensure that not more than 25% of the inventory of a vendor is from the marketplace entity or its group companies.

Corrective measures

Where a closely held company issues shares at a price which is more than its fair market value, the amount received in excess will be subject to tax in the hands of the company as income from other sources. The Central Board of Direct Taxes (**CBDT**) had previously notified that, investments received by startups would not be subject to such tax and also specified the procedure and criteria for start-ups to avail these tax benefits.

However, in February 2019, the Department for Promotion of Industry and Internal Trade (**DPIIT**) introduced new measures for taxation of angel investments, causing a considerable amount of confusion among startups. To rectify this, in March 2019 the CBDT confirmed that provisions governing angel tax will not be applicable to startups that have been recognised by DPIIT and comply with certain conditions provided in DPIIT's notification of February 2019.

Key conditions for startups to be eligible for an exemption from angel tax under the DPIIT notification include: **(a)** the aggregate amount of paid-up share capital and share premium or issuance or proposed issuance does not exceed INR 250,000,000 (approx. US$ 3.6 million); **(b)** the startup has not invested in certain specified assets (such as, immovable properties, loans or advances, shares or securities, capital in other entities) and does not invest in such assets up to a period of seven years from the end of the year in which its shares are issued at a premium.

Proposals requiring further clarifications

The current FDI policy allows FDI under the approval route up to 49% in up-linking of news and current affairs TV channels and up to 26% in print media, which includes publishing of newspapers and periodicals dealing with news and current affairs. Considering there was no restriction on digital publishing of news and current affairs, the general consensus was that FDI was permitted up to 100%. The recent announcement by the government however has expressly restricted FDI in digital media up to 26% for uploading / streaming of news and current affairs. The government has not provided any clarity on what will constitute 'digital media', what the implications would be on entities which currently have received FDI in excess of 26% and how this will effect media houses that have both a print and digital media presence.

7. **What are the preferred structures for investment in venture capital deals? What are the primary drivers for each of these structures?**

Typically, VCs acquire a minority stake of 10 – 15% in early stage investments by way of compulsorily convertible preference shares (**CCPS**) or a combination of equity shares and CCPS. CCPS rank in priority to equity shares on dividend distribution and repayment of capital on liquidation. CCPS also allow the investor to link the ratio of conversion to pre-agreed valuation expectations.

FVCIs looking to invest in startups can also subscribe to convertible notes. The primary advantage of a convertible note is that it allows an investor the flexibility to determine, within a five year period, whether the money invested should be repaid or be convert into equity shares on terms and conditions agreed with the target.

While determining the preferred structure, other considerations which play a key role include tax implications, exchange control considerations relating to the sector of investment as well as anti-trust and other regulatory analysis.

8. **Is there any restriction on rights available to venture capital investors in public companies?**

No. Securities regulations in India apply uniformly to all investors and shareholders of a public company, regardless of domicile.

Unlike private equity, VCs typically do not to invest in the listed space. An acquisition of control or 25% or more of voting rights in a listed company would trigger mandatory tender offer obligation. Financial investors are also generally cautious of not wanting to be categorised as 'promoters' of a listed company, on account of attendant legal and regulatory implications.

[**AZB**: *On second thought, as there is nothing unusual to be reported here, perhaps this question can be deleted.*]

9. **Is there a preference to acquire minority or majority stake in a venture capital transaction? What factors would encourage venture capital investors to acquire a controlling stake in a target entity?**

The preference to acquire a controlling or minority stake would depend on several factors such as the valuation of the target, stage of investment, estimated projections, exit options offered and scalability of the business.

As investment in startups is typically a high risk - high reward scenario, VCs typically prefer to initially acquire a minority stake. It is, however, not uncommon for VCs to end up owning a majority stake in the target, as a result of additional rounds of investments, where the founders' shareholding gets diluted with each round of fresh funding received by the target.

While minority acquisitions continue to be the norm, there has been an increase in the number of buyouts and control transactions. A buyout is generally preferred where the investor is looking to control the business of the company and not rely on the founders for providing an exit. This is however not possible in sectors which require residents to retain control. For instance, in case of single brand retail trading, Indian brands are required to be owned and controlled by resident Indian citizens and/or companies which are owned and controlled by resident Indian citizens.

10. **What protections are generally available to venture capital investors in your jurisdiction?**

Aside from standard contractual protections, transaction documents can also provide for an assured return on capital invested, provided this does not exceed the fair market value of the investment made by the investor in the target. Typically, we have seen investors opt for the higher of 1x their investment amount or the fair market value of their investment.

In addition, statutory protections available to minority shareholders include, **(a)** right to make an application with the national company law tribunal in case of mismanagement or where the company's affairs have been conducted in a manner that is oppressive to the interests of the members; **(b)** right to file a class action suit; and **(c)** right of small shareholders to appoint a director.

11. **Is warranty and indemnity insurance common in your jurisdiction? Are there any legal or practical challenges associated with obtaining such insurance?**

Traditionally, investors in the Indian context rely on contractual indemnities and the right to claim damages and specific relief in law. However, in recent years, we have seen investors increasingly opt for warranty and indemnity insurance in India. It is generally preferred in high value transactions where founders are exiting the company and the incoming investor would have to rely on personal guarantees of the promoters for performance of conditions under the transaction documents.

The exclusion of known risks, high premium and limited market of insurance brokers offering warranty and indemnity insurance in India, is likely to pose some practical challenges in obtaining such insurance.

12. **What are common exit mechanisms adopted in venture capital transactions, and what, if any, are the risks or challenges associated with such exits?**

In a typical venture capital deal, investors opt for a waterfall exit mechanism with multiple exit options. This usually includes exit through an initial public offering (**IPO**), a put option on the founders and buyback of capital. If the company / founders are unable to provide an exit through any of these mechanisms, as a last resort, investors reserve the right to sell their investment to a third party buyer along with the founders' stake in the entity by exercising a drag right.

Implementing each of these exit mechanisms in not without its challenges. The difficulties in achieving a successful an IPO have been discussed in our response below. While exercising a put option on the resident founders, an investor is permitted to do so only after having held the security for a period of one year. Further, the sale price of the investor's securities cannot exceed fair market value.

For implementing a buy back, Indian company law imposes certain limitations such as: **(a)** it should be permitted under the articles of association of the target; **(b)** funds used for buy back should be out of free reserves, securities premium or proceeds from issue of any shares or other specified securities; **(c)** the buy back cannot exceed 25% of the aggregate of paid-up capital and free reserves of the company; and **(d)** the ratio of the aggregate of secured and unsecured debts owed by the company after buy-back should not be more than twice its paid-up capital and free reserves. A subsequent offer of buy-back cannot be made within a period of one year reckoned from the date of the closure of the preceding offer of buy-back, if any.

13. **Do investors typically opt for a public market exit via an IPO? Are there any specific public market challenges that need to be addressed?**

While it is common for most VC deals to provide an exit via an IPO, a successful public market exit depends significantly on external factors such as market conditions and regulatory and political climate, which are beyond the control of exiting investors. This provides a very narrow timeframe, during which the exit can be achieved. Public market exits are highly regulated, and managing and implementing an IPO is a long drawn process typically taking a year to complete. It is also a promoter driven process, with the SEBI (Issue of Capital and Disclosure Requirements) Regulations, 2009 (**ICDR Regulations**) impose several eligibility conditions on the issuer company, such as having net tangible assets of INR 30 million, operating profits of INR 150 million and a net worth criteria of not less than INR 10 million, in each of the three years preceding the IPO. Other key challenges include: **(a)** in case of an offer for sale to the public, ICDR Regulations impose a lock-in on the sellers' shareholding for a period of one year prior to filing the draft offer document with SEBI; and **(b)** the post-issue capital should account for a minimum contribution from promoters' of 20% and will be locked in for a period of three years.'