Private Equity Investments in Indian Companies

April 2013

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I. Private Equity Investments In Indian Companies – An Introduction

Private equity and venture capital ("**PE**") has been a driver of growth in the world economy for decades. While growth and profitability remain the primary goals of the PE industry, the contribution of the PE industry to economic development is undeniable. Furthermore, the ability of timely investment to sustain and gestate ideas into economic realities has permitted the PE industry to take on a parental role in the economy. A number of standard terms of PE deals have not yet been tested in dispute and exits are only now starting to take place. There is still a lot to learn in terms of how PE transactions work in India.

1. Origin and Development of PE

The seeds of PE as an organized form of funding were sown in the aftermath of World War II. The first firms to enter the PE space are believed to be two US based PE firms, American Research and Development Corporation (ARDC) and J.H. Whitney & Co., both founded in 1946.[1] Despite being called private equity, the investments made by so-called PE firms assumed different forms at various stages of its evolution, starting off as venture capital investment (characterized by relatively small investments into early stage companies), and thereafter leveraged buyouts (facilitating exits to small business owners) and finally culminating into dedicated investments made by institutionalized PE players. The PE industry in the UK took off at around the same time as in the US, but suffered setbacks due to adverse investment conditions imposed by various governments. It was only in the mid 80's that the State took progressive steps to promote venture capital industry, rationalization of marginal tax rates, etc. The establishment of the Unlisted Securities Market (USM) in the early 80's proved advantageous for the exit of small firms because of relatively easier listing requirements.[2]

In India, PE is still relatively new – while early stage investment vehicles or venture capital funds were launched as early as the mid-1980s, it was only in the mid-1990s that dedicated PE firms started investing in Indian companies.[3]

2. Private Equity and Venture Capital

Private equity is often used interchangeably with venture capital. There are, however, key differences between the two kinds of investments. The first and key difference is with respect to the stage and quantum of investment. While private equity investments are larger in size and are targeted at growth stage companies, venture capital investments are smaller sized investments into early stage companies. Second, since venture capital investments are made with the intention of driving a company's growth, the nature of the rights negotiated are different vis-à-vis private equity investments.

3. Trends in India

Until early 2001, the focus of PE was skewed

1. 'A Short (Sometimes Profitable) History of Private Equity' by John Steele Gordon, accessed at http://online.wsj.com/article/SB10001424052970204468004577166850222785654.html
2. 'Evolution of Global Private Equity Market: Lessons, Implications and Prospects for India' by R. K. Jain and Indrani Manna, viewed at http://www.rbi.org.in/Scripts/bs_viewcontent.aspx?Id=2109
3. 'Evolution of Global Private Equity Market: Lessons, Implications and Prospects for India' by R. K. Jain and Indrani Manna, viewed at http://www.rbi.org.in/Scripts/bs_viewcontent.aspx?Id=2109

more towards high growth sectors such as Information Technology (“**IT**”). Since then, with the technology slowdown following the dot-com burst, PE investors diversified their interest into other high potential sectors such as manufacturing, infrastructure, e-commerce, pharmaceuticals and biotechnology.

Another effect of the global slowdown in 2008-2009 has been the shrinking deal sizes for PE investors. There has been substantial correction in valuations of Indian enterprises, and the extraordinary growth bubble has seemingly burst. PE investors have become much more cautious, and now appear more willing to invest in the traditional economy seeking reasonable and steady growth. 2011 saw the PE industry start returning to the pre-2007 era, with average investment sizes of around USD 236 Million (nearly equal to a similar statistic in 2007).[4] More importantly, 2011 saw the rise of private investments in public equity (“**PIPE**”) deals, with a close to double increase in the number of deals struck. However, 2012 was another year for smaller deals.

The last few years have also tested the legal strength of many deals, some investors have attempted to enforce their exit rights, few have succeeded. This is primarily on account of the regulatory restrictions that India imposes on foreign exits. These regulatory requirements and restrictions are discussed in greater detail in other parts of this paper.

4. Business Methods

The basic method by which PE investments work in India is not substantially different from the manner in which they work elsewhere. A typical investment commences with the PE investor seeking out a company requiring investment or being approached by such a company. Following this, a basic document, such as a memorandum of understanding, a letter of intent or a term sheet is executed between the investor and the company, in order to lay out the framework of the investment. Once the initial document is in place, the investor usually conducts, at the minimum, a legal and financial due diligence on the company. This is often accompanied by a business due diligence and a background check on the promoters of the company. Simultaneously with the due diligence process the investor and the company will negotiate one or more investment documents, including share subscription agreements, share purchase agreements and shareholders’ agreements with the company and the promoters/shareholders. Upon the execution of these documents, and the clean-up of significant diligence issues, the investor invests in the company.

4. Bain & Company, India Private Equity Report, 2012, page 6.

II. Regulatory Framework For Venture Capital And Private Equity Investments

1. Consolidated FDI Policy

The foreign direct investment ("**FDI**") policy in India is formulated by the Department of Industrial Policy and Promotion ("**DIPP**"), Ministry of Commerce and Industry, Government of India ("**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 FDI policy governing foreign investments in Indian companies is currently laid down in Circular No. 1 of 2013 issued by the DIPP (referred to as the "**Consolidated FDI Policy**").

2. FEMA and Other RBI Regulations

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 / general approval. While the Consolidated FDI Policy lays down the broad policy framework relating to foreign investments in India, the policy is administered and implemented through the exchange control laws. The Foreign Exchange Management Act, 1999 ("**FEMA**") and the rules and regulations issued under the FEMA regulate foreign investment in India. As and when the FDI policy of the DIPP is amended, the changes are reflected in the FEMA and/or the corresponding regulation, as applicable. The Reserve Bank of India ("**RBI**") and the GoI is empowered to frame detailed regulations and rules in respect of various aspects of exchange control. These regulations and rules supplement the Consolidated FDI Policy.

The issuance of shares and dealings in shares are governed by the Foreign Exchange Management (Transfer or issue of security by a person resident outside India) Regulations, 2000 (the "**FI Regulations**"). The RBI has also issued Master Circular No. 15/2012-13 on July 2, 2012 (the "**RBI Master Circular**") consolidating its rules governing foreign investment in India.

The FI Regulations have, from time to time, on a progressive basis, been liberalizing the exchange control regime of India. Sub-regulation 5 of the FI Regulations lays down the conditions subject to which foreign investors would be permitted to invest into Indian securities. For the purpose of analysis, Sub-regulation 5 has been classified into its sub components in the **Table No. 1** below.

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Table No. 1

Classification of Regulation 5 of FI Regulations		
Sub regulation	**Deals with**	**Applicable schedule**
5(1)	Investments by persons resident outside India (other than citizens of Bangladesh and Pakistan) and entities incorporated outside India	Schedule 1 (the "**FDI Scheme**")
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 QFIs, 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	-
5(7)	Investments by NRIs out of INR funds on non-repatriation basis	-

Each of the schedules to the FI Regulations (as referred to in the above table) lay down specific conditions governing the investment by that particular category of investors.

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

- The investment should be within the sectoral equity caps prescribed, where applicable.
- The investment should not be in a company which is engaged in the activity of manufacture of items listed in Annexure A to Schedule I of the FI 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 the pricing guidelines specified under the FI Regulations. For subscription to shares of an unlisted company, the minimum price to be paid by the non-resident investor is linked to the valuation of the company, determined as per the discounted cash flow method of valuation ("**DCF Value**"). If the shares of an unlisted company are being transferred by a non-resident to a resident, the price payable should not exceed the DCF Value mentioned above. In case of transfer of shares of a listed company (where the shares are being transferred by a resident to a non-resident), then the minimum price shall be as prescribed under the applicable Securities and Exchange Board of India ("**SEBI**") Regulations such as the SEBI (Issue of Capital and Disclosure Requirements) Regulations,

2009 ("**ICDR Regulations**"), SEBI takeover code etc.

However, as will be discussed later, an exemption has been provided from this entry-pricing requirement for investments made by foreign investors under the foreign venture capital investor route (i.e. under Schedule 6 of the FI Regulations).

A special scheme for portfolio investment has been formulated for investments by Foreign Institutional Investors registered with SEBI ("**FIIs**").[5] A single FII is permitted to invest in 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 FIIs put together should not exceed 24% of the paid-up equity capital or paid up value of each series of convertible debentures. However, this limit may be increased by the Indian company, up to the sectoral cap as applicable, by a resolution of the board followed by a special resolution of the shareholders[6], to that effect.

In cases where any of the provisions of the FI 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**").[7] The FIPB normally takes between 6-8 weeks to clear proposals. Transfers between two non-residents do not require any regulatory approvals from Indian authorities.[8]

3. The QFI Route

On January 1, 2012, the Ministry of Finance issued a Press Release proposing to allow Qualified Foreign Investors ("**QFI**") to invest directly into the Indian equity market. In pursuance of this, on January 13, 2012 the SEBI vide Circular No. CIR/IMD/FII&C/3/2012 ("**SEBI QFI Circular**")[9] and the RBI vide A.P. (DIR Series) Circular No. 66 ("**RBI QFI Circular**")[10] formalized the scheme for investment by QFIs in equity shares of Indian companies. With this a new avenue has now opened up for foreign investors to invest into Indian entities.

'QFI' is defined by SEBI[11] as follows:

"QFI shall mean a person who fulfills the following criteria:

*(i) Resident in a country that is a member of Financial Action Task Force ("**FATF**") or a member of a group which is a member of FATF[12]; and*

(ii) Resident in a country that is a signatory to IOSCO's MMOU (Appendix A Signatories) or a signatory of a bilateral MOU with SEBI:

Provided that the person is not resident in a country listed in the public statements issued by FATF from time to time on - (i) jurisdictions having a strategic Anti-Money Laundering/ Combating the Financing of Terrorism (AML/CFT) deficiencies to which counter measures apply, (ii) jurisdictions that have not made sufficient progress in addressing the deficiencies or have not committed to an action plan developed with the FATF to address the deficiencies:

Provided further that such person is not resident in India:

5. Schedule 5 of the FI regulations.
6. A special resolution requires at least 75% of the shareholders present and voting to approve the resolution.
7. Regulation 10 of the FI Regulations.
8. *Ibid.*

9. http://www.sebi.gov.in/sebiweb/home/list/1/7/0/0/Circulars
10. http://www.rbi.org.in/scripts/BS_CircularIndexDisplay.aspx?Id=6937
11. SEBI circular CIR/IMD/FII&C/18/2012, dated July 20, 2012
12. The inclusion of member of a group which is a member of FATF was brought about pursuant to the MoF Press Release. Thus now, along with residents of 34 member-countries of FATF, residents of 6 member countries of Gulf Cooperation Council ("GCC") and 27 member countries of the European Commission ("EC") can also invest under the QFI regime.

Provided further that such person is not registered with SEBI as Foreign Institutional Investor or sub-account or Foreign Venture Capital Investor.

Explanation - For the purposes of this clause:

(1) The term "Person" shall carry the same meaning under Section 2(31) of the Income Tax Act, 1961;

(2) The phrase "resident in India" shall carry the same meaning as in the Income Tax Act, 1961;

(3) "Resident" in a country, other than India, shall mean resident as per the direct tax laws of that country.

(4) "Bilateral MoU with SEBI" shall mean a bilateral MoU between SEBI and the overseas regulator that inter alia provides for information sharing arrangements.

(5) Member of FATF shall not mean an Associate member of FATF."

Thus, a QFI is a person resident in any of the member countries of FATF, GCC or EC and is not registered in India with SEBI as an FII or sub-account or FVCI (explained below). On May 29, 2012, the Ministry of Finance issued a Press Release[13] to make further liberalizations in the investment regime by QFI under the portfolio investment scheme ("**PIS**") wherein it was proposed to allow QFIs to invest in debt securities. Pursuant to this press release, the RBI and SEBI also released circulars that govern investment by QFIs in India.

Debt investment in an Indian company through the QFI route can be made by using the following securities[14]:

- Corporate debt securities (including NCDs and bonds) listed / 'to be listed' on any recognized stock exchange;
- Corporate debt securities, through public issues, if the listing on a recognized stock exchange is committed to be done as per the relevant provisions of the Companies Act, 1956;
- Listed units of mutual fund debt schemes;

If the 'to be listed' eligible debt securities could not be listed within 15 days of the issue, then the holding of QFIs must be sold only to domestic participants / investors until the eligible debt securities are listed.

The investment by QFIs in eligible debt securities shall not be more than USD 1 (one) billion and such investment shall not be subject to any lock-in or residual maturity clause. This limit on investment by QFIs shall be over and above USD 20 (twenty) billion allowed for investment by FIIs in corporate debt. Of this limit, QFIs may invest in eligible debt securities without any permission until the aggregate investment by all the QFIs reach 90% of the debt limit i.e. USD 0.9 billion. Thereafter, QFIs would be allocated the balance debt limit on a first come first serve basis, wherein the depositories would on each day after the market hours coordinate with each other to provide approval to the requests based on the time of receipt of the requests. However, there is no individual investment limit specified for the QFI investment in eligible debt securities, as opposed to FIIs wherein there is a cap on the amount of limit a FII could bid for.

Thus a foreign investor, who qualifies as a QFI, can directly invest under these routes into debt securities and the listed equity shares of a company. This route provides foreign investors direct access to the Indian equity and debt markets especially to the high net worth individuals, who do not wish to pool their funds with others. However, SEBI has provided that for the investment in listed equity shares of

13. F. No. 10101/2011-ECB, available at http://finmin.nic.in/press_room/2012/Rational_QFI_Scheme.pdf
14. SEBI circular CIR/IMD/FII&C/17/2012, dated July 18, 2012 read with RBI circular RBI/2012-13/134, dated July 16,2012

the company the ultimate beneficiary would be looked at and such ultimate beneficiary details would have to be obtained by the depository participant to fulfill the KYC requirements. This condition is applicable for QFI investment via the debt route also. Further, the investment by QFIs is subject to an individual investment limit of 5% of the paid up capital of the Indian company and an aggregate investment limit of 10% of the paid up capital of the company.

4. Venture Capital Funds

In India, both domestic and offshore venture capital funds investing in India are regulated by the SEBI.

a. The SEBI (Foreign Venture Capital Investor) Regulations, 2000

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 and registered domestic venture capital funds ("**VCF**") some of which include:

- **Free pricing:** Registered FVCIs benefit from free entry and exit pricing and are not bound by the pricing restrictions applicable to the FDI investment route. However, this relaxation to FVCIs may be limited in light of the recent amendment to the income tax laws in India. Pursuant to the amendment, FVCIs may be liable to pay tax on 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.

  The exemption from pricing guidelines was a very significant benefit from an FVCI's point of view especially with respect to exits from unlisted companies through strategic sales or through buy-back arrangements with the promoters and the company.

- **Exemption under the Takeover Code:** SEBI has also exempted promoters of a listed company from the public offer provisions in connection with any transfer of shares of a listed company, from FVCIs to the promoters, under the Takeover Code.

- **Status of QIB in IPO:** FVCIs registered with SEBI have been accorded Qualified Institutional Buyer ("**QIB**") status and are eligible to subscribe to securities at the Initial Public Offering ("**IPO**") through the book-building route.

- **QIP route:** FVCIs (as well as VCFs) by virtue of being QIBs, are eligible to subscribe to the securities of Indian listed companies under the Qualified Institutional Placement route as prescribed under the ICDR Regulations. Under this route, as compared to Chapter VII of the ICDR Regulations which governs preferential allotment or private placements by a listed company, there is no lock-in on the securities so allotted (as long as they are traded on the stock exchange) and the time-period of conversion of convertible securities is 60 months (i.e. 5 years) as opposed to the 18 month period prescribed for preferential allotment. Additionally, the shareholders' resolution authorizing the issuance under the QIP route is valid for 1 year (as compared to the 15 day period in the case of a 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 both of which are not pre-requisites for a preferential allotment under the ICDR Regulations.

- **Lock In:** Under the ICDR Regulations, the entire pre-issue share capital (other than certain promoter contributions which are locked in for a longer period) of a company conducting 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 registered VCFs 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 SEBI. This exemption permits the FVCI to exit from its investments, post-listing.

i. Eligibility Criteria

In order to determine the eligibility of an applicant for registration as an FVCI, 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 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.

ii. Investment Conditions and Restrictions

Investments by an FVCI would be subject to the following conditions:

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

2. At least two-thirds of the FVCI's investible funds must be invested in unlisted equity shares or equity linked instruments of a Venture Capital Undertaking ("**VCU**").

3. Further an FVCI can invest up to 33.33% by way of:

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

   - Debt or debt instruments 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 regulations.

A VCU is a domestic company whose shares are not listed on a recognized stock exchange in India and which is not engaged in activities which have been classified under the negative list. The negative list broadly includes 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.

The FVCI must appoint a domestic custodian and 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 an ongoing basis.

The RBI has in recent years qualified the FVCI registrations by stipulating that the FVCI must invest 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 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.

iii. Certain Issues

- **Investment in 'Trusts'**

An FVCI can 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. Further, investment in a trust which is not registered with SEBI as a VCF is not permitted.

- **Taxation of Equity Investments Made at Less than 'Fair Market Value'**

The Ministry of Finance, GoI, amended the Income Tax Act, 1961 (**"ITA"**), introducing Section 56 (viia), effective from June 01, 2010. Under Section 56 (viia), tax is levied on companies and firms that 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. It is important to note that the fair market value computed under the amended Income Tax Rules, 1962[15] is in the nature of a net asset value computation for unlisted companies.

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

- **Issuance of Shares at More than 'Fair Market Value'**

An additional amendment was also brought about to Section 56 to insert a new sub-clause, Section 56(viib) which provides that if a company issues shares at more than the face value, then any consideration that is more than the fair market value shall be brought to tax in the hands of the issuing company as income from other sources. In this regard, it may be noted that investment by a venture capital company or venture capital fund is excluded from the purview of Section 56(viib). In determining what constitutes fair market value, as per the Income Tax Rules, the same can be either the net asset value or DCF value and in other cases, has to be substantiated before the income tax authorities. As in the case of Section 56(viia), the clause does not apply to public listed companies and in situations where the difference is less than INR 50,000.

b. The SEBI (Venture Capital Funds) Regulations, 1996 and SEBI (Alternative Investment Funds) Regulations, 2012

Until 2012, the private equity fund formation regime in India was largely regulated by the SEBI (Venture Capital Regulations) 1996.

15. Effective from April 1, 2010

On May 21, 2012 SEBI notified the SEBI (Alternative Investment Funds) Regulations, 2012 ("**AIF Regulations**") and thereby repealed the VCF Regulations. The roadmap for the Indian fund industry laid out by the AIF Regulations is a clear departure from the preceding regulatory platform (i.e. VCF Regulations). The objective of the AIF Regulations is to extend the perimeter of the regulation to unregulated funds with a view to systemic stability, increasing market efficiency, encouraging formation of new capital and consumer protection.

Under the AIF Regulations, pooling vehicles have been categorized into three types, Category I AIF, Category II AIF and Category III AIF. Each category is sub-divided into different types of funds and is subject to the conditions and restrictions provided under the AIF Regulations.

i. Status of VCFs and Current Relevance of the VCF Regulations

Existing venture capital funds registered with SEBI and unregistered pools of capital have been grandfathered. Venture capital funds that are registered under the VCF Regulations would continue to be governed by the VCF Regulations; however, they have been prohibited from launching any new schemes or increasing the targeted corpus of their existing schemes. Also, these funds are permitted to migrate to the AIF Regulations by re-registering under these regulations after receiving an approval of two-thirds of their investors (by value).

5. AIF Regulations

a. Introduction

An AIF has been defined as any body which is a privately pooled investment vehicle which collects funds from investors for investing in accordance with a defined investment policy for the benefit of its investors. An AIF can be organized in the form of a trust, a company, limited liability partnership or as a "body corporate". The following pooling vehicles have been exempted from the AIF Regulations:

- Collective Investment Schemes under the CIS Regulations;
- Family trusts set up for the benefit of 'relatives' as defined under the Companies Act, 1956;
- ESOP Trusts set up under the SEBI (Employee Stock Option Scheme and Employee Stock Purchase Scheme), Guidelines, 1999 or as permitted under the Companies Act, 1956;
- Employee welfare trusts or gratuity trusts set up for the benefit of employees;
- 'Holding companies' within the meaning of Section 4 of the Companies Act, 1956;
- Other special purpose vehicles not established by fund managers, including securitization trusts, regulated under a specific regulatory framework;
- Funds managed by a securitisation company or reconstruction company which is registered with the RBI under Section 3 of the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002; and
- Any other pool of funds that is directly regulated by any other regulator in India.

b. Structuring Considerations

Although an AIF may be setup as either a company, trust or an LLP, 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 AIF 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 the 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 class other than those being redeemed). Thus, in a loss situation it would be difficult to redeem shares.

- 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.

The LLP structure is a new introduction in the Indian corporate jurisprudence and is yet to fully take off. However, some fund managers have sought to obtain the benefit of the LLP structure since the launch of the AIF Regulations. However, the tried and tested trust structure and the ability to obtain tax benefits continues to drive AIF structuring in the form of trusts.

c. AIF Classifications

As noted above, the AIF has created three broad categories of AIFs tailored based on the investment objectives of the pooled capital, the investment strategy sought to be employed as well as the products in which the pooled capital will seek to invest. Please refer to **Table No. 2** for an illustrative list of fund types and the categories into which they are likely to fit.

Table No. 2

Type of Fund	Permissible Investments	Category
Infrastructure Fund	Unlisted securities or partnership interest or listed debt or securitized debt instruments of companies or SPVs engaged in or formed for the purpose of operating, developing or holding infrastructure projects.	Category 1
SME Fund	Unlisted securities of companies which are SMEs or securities of those SMEs which are listed or proposed to be listed on an SME exchange or SME segment of an exchange.	Category 1
Social Venture Fund	Securities or units of social ventures which satisfy performance criteria laid down by the fund and whose investors may agree to receive restricted or muted returns.	Category 1
Venture Capital Fund	Unlisted securities of start-ups, emerging or early-stage venture capital undertakings mainly in volved in new products, new services, technology or intellectual property right based activities or a new business model.	Category 1
Debt Fund	Debt or debt securities of listed or unlisted investee companies.	Category 2
Private Equity Fund	Equity or equity linked instruments or partnership interests of investee companies	Category 2
Hedge Fund	Invests and trades in securities having diverse risks or complex products including listed and unlisted derivatives	Category 3

Several mandatory requirements are imposed on AIFs, such as:

- Maximum numbers of investors is 1000 investors;
- Minimum corpus of each fund/scheme must be at least INR 200 (two hundred) million;
- Minimum investment from each investor must be at least INR 10 (ten) million;
- Close ended schemes / funds may be listed subject to the minimum trade-able lot being at least INR 10 (ten) million.

In addition, specific requirements are imposed on different categories of AIFs on several fronts including the requirement to maintain minimum sponsor / investment manager commitment, maximum limit on investments, maximum limit and extent of borrowings, requirements for valuing investments, nature of funds, ability to list the funds and requirement to appoint custodians for securities held by the AIFs.

6. The Investment Advisor Regulations

On January 21, 2013, the SEBI notified the SEBI (Investment Advisers) Regulations, 2013 ("**IA Regulations**"). Some key changes include:

- Extending exemption from registration to investment advisers providing investment advice exclusively to clients based outside India; and

- Extending exemption from registration to fund managers of all intermediaries or entities registered with SEBI. The exemption would now also extend to managers of venture capital funds that are registered with SEBI under the erstwhile SEBI (Venture Capital Funds) Regulations, 1996.

Under the IA Regulations, the term 'investment adviser' has been defined to mean *any person who is engaged in the business of providing investment advice to clients or other persons or group of persons, for a consideration, and includes any person who holds out himself as an investment adviser by whatever name.* Further, 'investment advice' *means advice relating to investing, purchasing or dealing with securities and advice on investment portfolio containing securities or investment products which may be written, oral or through alternate means, for the benefit of the client, including financial planning.*

a. Eligibility Criteria for Registration as an Investment Adviser

Registration depends on the form of the adviser, i.e. whether an applicant is a body corporate, firm, limited liability partnership or an individual. Other factors include previous disciplinary history in the context of the securities market as well as any past refusal of registration by SEBI under any other regulation. Further, additional disclosures are required to be made in case of a bank or a non-banking financial company.

b. Obligations and Compliances

The IA Regulations also set out the obligations of the investment adviser, including carrying out risk profiling for the clients, maintenance of records and making relevant disclosures to enable the client to take an informed decision on whether to procure the services of the investment adviser.

III. Structuring Of Foreign Investments

India taxes the worldwide income of its residents, subject to tax treaty benefits 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 scheduled. 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 2013-2014 to residents as well as non-residents in respect of the various types of income (in relation to securities) earned in India have been summarized in **Table No. 3** given below:

Table No. 3

Category	Status	Capital Gains				Dividend/Withholding
		Long Term#		Short Term		
		Listed	Unlisted	Listed	Unlisted (and listed securities other than equity shares)	
Individual	Resident	0*/10%**	20%	15%*	30%	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%. Dividends received by an Indian company from a foreign company would be taxed at the rate of 15%, while any other person receiving dividends would pay tax at ordinary rates applicable.
	Non-Resident	0*/10%**	10% (without forex conversion and indexation benefit)	15%*	30%	
Corporate	Resident	0*/10%**	20%	15%*	30%	
	Non-Resident	0*/10%**	10% (without forex conversion and indexation benefit)	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, the 0% rate applies for long term capital gains and 15% rate applies for short-term capital gains – but only for equity shares or units of equity oriented funds.

**For transactions outside the stock exchange - the lower of 10% (without indexation benefit) or 20% (with indexation benefit) would apply to all securities.

*** FIIs would pay tax at the rate of 30% for short-term capital gains from unlisted shares.

****10% in the case of investments in securities of unlisted public companies.

The above rates are exclusive of the currently applicable surcharge of 5% for Indian resident companies and 2% for non-residents, and a 3% education cess on tax plus surcharge, payable by all taxpayers. These rates are as per the Finance Act, 2013.

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. A 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 a mutual fund, STT at the rate of 0.25% would be applicable. Further, any sale of unlisted securities under an offer for sale to the public will be subject to STT at the rate of 0.2%. The STT can be set off against business income tax calculated as per the provisions of Indian tax law, provided the gains on the transaction are offered to tax business income and not as capital gains.

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 1961, 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 provides 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;
- Whether there are bi-lateral investment protection agreements – to ensure protection of capital.

Depending on the nature of income and the Indian operations, various jurisdictions like Mauritius, Singapore, Cyprus, Netherlands 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 capital gains from such transfers 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.*[16] In that case, the Supreme Court of

16. *Union of India and Anr. v. Azadi Bachao Andolan and Anr.* (2004) 1 CompLJ 50 SC

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. However, in light of the financial crisis that has engulfed Cyprus, it has not generally been used in the recent past for undertaking investments into Indian companies and many investors have been considering re-structuring their investment made through Cyprus.

Singapore has over the recent past found a lot of favour in respect of undertaking investments into India. The tax treaty between India and Singapore allows for capital gains in respect of transfer of shares of an Indian company to be taxed only in Singapore and not in India. Since Singapore does not levy capital gains tax, this has usually been used as preferred route in the recent past. However, the tax treaty between India and Singapore provides that the benefit of the capital gains will be allowed only if a) it is not a shell / conduit entity and b) the Singapore entity has not been set up for the primary purpose of taking benefit of the capital gains tax benefit. Where a Singapore entity spends more than S$ 200,000 in the 24 months preceding the realization of capital gains, in such case, it will be deemed not to be a shell / conduit entity. Additionally, it must be noted that under Singapore law, there are certain income characterization issues that may arise on whether the gains will be treated as capital gains or business income.

However, please note that as per the Finance Act, 2012 and Finance Act 2013, in order to be entitled to claim relief under a treaty, the Government of India requires a non-resident to provide a tax residency certificate and such other documents and particulars as may be prescribed by the Government of India, of the non-resident being a resident in any country outside India, from the Government of that country.

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, while for the purpose of investing in India, the use of intermediate jurisdictions has been extensive, a word of caution is not misplaced at this stage. It is important to note that India is introducing General Anti-Avoidance Rules – which may have an impact on availability of treaty benefits to the investor. Additionally, there have been a number of instances where even absent the General Anti-Avoidance Rules, the tax authorities have been challenging structures on the basis of substance and that the intermediate entity is not the actual owner of the underlying shares of the Indian entity. In such cases though, the Courts have usually found in favour of the entitlement to treaty benefits, except in exceptional cases. 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.

Further, the Supreme Court of India in the recent case of *Vodafone International Holdings*

B.V. v. Union of India and Anr [17] ("**Vodafone Case**") set out important principles of law and most importantly upheld the *Azadi Bachao Andolan case*[18] which enunciated the principle that a TRC issued by the Mauritian tax authority would constitute sufficient evidence for the applicability of treaty benefits in the absence of a 'Limitation of Benefits' provision. However, the court held that the Indian tax authority can disregard such devices and take into account the real transaction between the parties, and subject it to tax in India in the event of a tax fraud or where an overseas entity is used by an Indian resident for round-tripping or for other illegal activities.

On the other hand, the lower level tax authorities have begun to take an aggressive stand and have started looking at Mauritius-based structures more closely. In the case of *E*Trade Mauritius Limited,*[19] 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.[20] Please note that in recent rulings, the validity of the Mauritius treaty has been upheld by courts in India, however, the lower level tax authorities have in most instances challenged or denied the availability of treaty benefits to investors using Mauritius-based structures.

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, both in terms of ensuring that there is adequate substance and commercial justification that is established and also to ensure that there are no risks exposing the investor to a permanent establishment ("**PE**") in India. Under the India-Mauritius Tax Treaty, if the investor 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 PE status, all investment decisions must be taken and effective management must be carried out, outside 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 investor fund from India.

Further, with the introduction of the General Anti-Avoidance Rules ("**GAAR**") with effect for assessment year 2014-2015, transactions relating to investments made will be subject to a greater scrutiny in light of the powers provided under GAAR. The GAAR provisions allow the tax authorities to tax 'impermissible avoidance arrangements' including the power to disregard entities in a structure, reallocate income and expenditure between parties to the arrangement, alter the tax residence of such entities and the legal situs of assets involved, treat debt as equity and vice versa. In doing so, the tax authorities may also deny tax benefits even if conferred under a tax treaty.

The term 'impermissible avoidance arrangement' has been defined very broadly to mean an arrangement where the main purpose (or one of the main purposes) is to obtain a tax benefit and which contains any of the following elements:

a. Non-arm's length transactions;
b. Misuse or abuse of the Act;
c. Non-bona fide purposes; and
d. Lack of commercial substance.

An additional aspect that should also be borne in mind in respect of structuring investments is relating to Indian taxes on indirect transfer of assets located in India. The Finance Act, 2012 has also introduced a provision for the levy of capital gains tax on income arising from the

17. (Civil Appeal No. 733 of 2012 (arising out of S.L.P. (C) No. 26529 of 2010).
18. 263 ITR 706
19. *E*Trade Mauritius Limited [2010]* (324 ITR 1) (AAR)
20. A ruling by the Authority for Advance Rulings subsequently ruled in favour of the taxpayer in this case.

transfer of shares / interest in a company / entity organized outside India which derives, directly or indirectly, its value substantially from the assets located in India. Therefore, in a situation where the shares of an offshore entity holding substantial Indian assets are being sold, the same may be subject to potential Indian taxes. However, please note that considering the ambiguity relating to the provisions, the scope and limit for indirect transfer has been reviewed by the Shome Committee and further amendments are expected to be made in respect of the same by the Government.

Therefore, appropriate structuring continues to be of vital importance, and investors should keep the aforementioned issues in mind.

IV. Structuring The Investment

1. The Entity

Incorporated entities in India are governed by the provisions of the Companies Act, 1956. The authority that oversees companies and their compliances is the Registrar of Companies ("**RoC**"). Companies may either be 'private limited companies' or 'public limited companies'. It is relevant here to point out the distinction between private and public companies:

- **Private Limited Company:** A private limited company must have a minimum paid-up share capital of INR 100,000. A private company has the following characteristics: it restricts the right to transfer shares; the number of members in a private limited company is limited to 50 members (excluding the present and past employees of the company); it cannot invite the public to subscribe to its securities; it cannot invite or accept deposits from persons other than members.

- **Public Limited Company:** A public limited company must have a minimum paid-up share capital of INR 500,000. A company which is not a private company is a public company. A private company which is a subsidiary of a public company, is also treated on par with a public company in some cases. A public limited company may have more than 50 shareholders, and may offer its securities to the public and invite deposits from the public. As compared to private companies, public companies are governed by a more stringent and restrictive regulatory regime.

PE investments are usually made into private companies because they permit enforcement of several standard deal terms such as rights of first refusal/offer, tag-along rights and promoter lock-ins. It is also easier to structure different classes of securities in a private company.

2. 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 instrument it should subscribe to against its investment, and what level of protections and risks the investor should bear in mind with respect to these instruments.

The simplest and perhaps the most obvious instrument that an investor can get would be the equity share. It must be noted that under Indian law, foreign investors may only subscribe to equity or equity-linked instruments under the FDI route. for several reasons, an investor may wish to hold a part or whole of its investment in the form of an equity linked instrument.

- If the value of the entity cannot be determined with certainty or is determined on the basis of projections of future business, revenue and growth, then the investor may not want to hold an unchangeable economic interest in the company. If investment is made in plain equity, it becomes difficult to vary the % holding of the investor unless shares are bought back by the company or more investment is made by the Investor. Buy back requirements are very restrictive and in most cases, a buyback is practically impossible. Since shares cannot be issued at less than the DCF value, further investment is also usually not an option.

- The investor may wish to receive a periodic return on their investment (in the form of preferential dividend or interest).

- The investor may wish to receive a preferential return on the investment at the time of exit (structured as a liquidation preference).

- The investor may wish to have differential voting rights, i.e. voting rights that are disproportionate to their economic interests.

Given the above reasons, the following alternate instruments are usually resorted to by investors in Indian companies. 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 instrument best suits the needs of an investor.

3. Instruments Denominated in Indian Rupees

- **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. The primary benefit is that this instrument permits adjustment of shareholding in case of any change in valuation of the company.[21] If the company does not perform as expected, the documentation may provide a formula for adjustment of the fully diluted shareholding to compensate the PE Investor.

  Under the FDI Scheme only preference shares which are fully and mandatorily convertible into equity shares are eligible to be issued to foreign investors. The RBI has prescribed that the rate of 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 prevailing on the date of the board meeting approving such issuance.

- **Convertible Debentures –** Debentures, in their essence, are debt instruments. In the case of a convertible debenture, the debenture holder is entitled to receive interest from the company till the maturity date of the instrument, after which the debentures would be converted into equity shares.

  Under the FDI Scheme only debentures which are fully and mandatorily convertible into equity shares are eligible to be issued to foreign investors. As far as the rate of interest on the debentures issued to non-residents is concerned, the FDI Scheme is silent. 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 issued to non-residents is 300 basis points over the PLR of the State Bank of India.

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21. Law requires that the conversion price or formula should be fixed at the time of the investment.

Table No. 4

	EQUITY	CCPS	CCD
Basic Character	Participation in governance and risk based returns	Preference of equity in respect of dividend and repayment of capital, convertible into equity	Debt, must be converted into equity
Liability to Pay	No obligation to declare dividend	No obligation to declare dividend	Mandatory payment of interest
Limits on Payment	No cap on dividend	Dividend on CCPS cannot exceed 300 basis points over and above the prevailing SBI PLR. No legal cap on interest on CCDs, however, in practice it is benchmarked to CCPS limits.	
Liquidation Preference	CCDs get preference over CCPS. CCPS get preference over Equity.		
Convertibility	No convertibility advantage as in the case of CCPS.	The conversion formulae can be based on the performance of the company.	
Price Protection (anti-dilution protection)	Difficult to achieve.	Easier because of ability to adjust conversion price.	

4. Instruments Denominated in Foreign Currency

Liquidity in an international market may be critical for an investor, and instruments denominated in foreign currency would provide such liquidity. 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).

V. Documentation

The documentation for a typical PE transaction consists of a share subscription agreement (or a share purchase agreement in the case of a secondary purchase) and a shareholders agreement. There may be other documentation agreed on between the parties depending on the structure and other terms of the deal, such as an escrow agreement for safeguarding shares, consideration or assets, or an employment agreement binding promoters to certain terms required by the Investor, etc. In this part, we discuss some of the customary terms in the share subscription agreement and the shareholders agreement.

1. Share Subscription Agreement (SSA)

a. Representations, Warranties and Indemnities

The critical portions of the SSA are the representations, warranties and indemnities provided by the company and the promoters to the Investor. Representations and warranties are essentially statements of fact (and sometimes opinion) made by the company and the promoter in relation to the business and affairs of the company – including regarding compliance with law, business practices, debt, employment policies, taxes and disputes etc. While these statements are termed 'representations and warranties', in most cases they are merely representations and would probably not be warranties. This is because such statements would generally be with reference to a specific point in time (i.e. when the investment is made) and not for a future period; a warranty implies that a promise is made with respect to a future period, - e.g. a promise that a certain device will work in a certain manner for a certain period. Such kinds of promises are rarely made with respect to the business of a company (they may be made for future compliance with law for specific things that a company needs to do). Generally, a failure of a representation does not lead to a claim for damages. A misrepresentation would render the contract voidable at the instance of the innocent party, who would be entitled to cancel the agreement and not perform his part of the contract. Courts have held that in certain cases damages may also be awarded to the innocent party if it is not possible to undo the contract and restore the innocent party to his original position.

Indian contract law permits the award of damages only if it is established that the contract was breached and losses were suffered. However, it may be possible that an investor suffers a loss even though there may not be an actual breach of contract.

An indemnity may be critical, where it is difficult or not possible to claim damages. An indemnity is a specific contract where the company / promoter promises to ensure that the investor will not suffer any loss (or the investor will be reimbursed or held harmless from any loss) on account of:

a. any specific events, acts or omissions whether or not known to the Investor – usually indemnity is claimed for any loss caused on account of any event etc., that occurred prior to the investment into the company;

b. breach of representations (and warranties) and covenant;

c. fraudulent / corrupt/ negligent acts of the company / promoters, etc.

2. Shareholders Agreement

a. Transfer Restrictions

A PE investor usually wants the promoters of the Indian company to remain with the company until such time the investor is invested with the company, and places restrictions on the transfer of shares held by the promoters. Some restrictions are discussed below. The enforceability of each of these restrictions should be examined in the context of a public / private company. In a public company shares are freely transferable. A private company, by its very nature is required to impose restrictions (but not absolute prohibitions) on the transfer of its shares.

i. Promoter Lock-in

A promoter may be locked in for a specified period of time and in such a case transfer is permitted only with the investor's consent. This may, in certain circumstances, be enforced by an escrow mechanism involving a release of the promoter's shares on a pre-determined schedule. Again, the permissibility of such transactions may be called into question, especially where the investor is a non-resident – it may, in some cases, amount to creation of a security in favour of a non-resident, which requires prior regulatory approval.

ii. Right of First Offer (ROFO) / Refusal (ROFR)

A 'right of first offer' means that the investor has the right to be offered any shares the promoter wants to sell, before the promoter offers the shares to a third party. A right of first refusal would require that the promoter does not sell to any existing identified third party without first offering shares to the investor. In the case of a right of first offer, the investor effectively determines the price of the shares at its own cost (and possibly peril) and this price effectively acts as the floor price for the promoter when he approaches third parties. In the case of a right of first refusal, the price offered by a third party becomes the minimum price which the investor will have to pay to exercise the right. Investors usually prefer a ROFO to a ROFR. The promoter may sometimes have a ROFR vis-à-vis the investor.

iii. Tag-along / Co-sale Right

A tag-along or co-sale right is usually exercisable by an investor when he does not exercise the ROFO/ROFR. The investor tags along with the promoter when he sells to a third party. He transfers all or a proportionate amount of his shares (alongside the promoter) to the third party, on the same terms and price offered to the promoter. A tag-along right is a form of exit for the investor.

b. Downside Protection

Downside protection essentially means protection when things go wrong with the investee company. One of the most important considerations is to have in place adequate downside protections in the documentation. This consideration also influences the investor's choice of instrument. While such protections are quite common and standard for investors from the US, UK, etc., they 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, the investor seeks 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 shares to another person at a price that is lower than the investor's entry price, then such investor would be entitled to the benefit of the lower price and receive additional shares at no additional cost. The ratchet may be a full ratchet, broad based or narrow based anti – dilution. A full ratchet basically means that the investor's price of investment is brought down to the price at which the new investor receives shares. Narrow based and broad based formulae use the same concept but reduce the number of additional shares that the investor receives by factoring in the size of the issue to the new investor (if the issue size is large, then more shares to the existing investor). The difference between narrow and broad based formulae is simply that the first does not factor in convertible instruments, while the latter assumes conversion of all such instruments (such as stock options).

While this is a fairly accepted term in virtually all private equity investments, Indian law poses certain practical difficulties in giving effect to any kind of anti-dilution mechanism:

- No shares can be issued by a company at a discount to par value without the prior approval of the Central Government.[22]

- Pricing requirements apply to investments by foreign direct investors. Please refer to the discussion on DCF value above.

Therefore, it is not possible to issue shares at no cost to any shareholder as envisaged in the ratchet mechanism.[23] One has to find indirect and often complicated means of enabling 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. However, this is not a tried and tested mechanism and has its own risks associated with it. The issuance of bonus shares to a non-resident investor falls under the automatic route, subject to the condition that the issued shares shall bear the same terms as the shares already held by the non-resident investor. 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, however, a recent press release issued by the SEBI appears to indicate that such waiver may be validly recognized.[24] Secondly, under Indian company law, a bonus issue can be funded only out of distributable profits of the company or from the securities premium account.[25] Therefore, if a company does not have sufficient distributable profits or funds in the securities premium account, this mechanism would not work.

- **Issuance at Lowest Legally Permissible Price[26]**

This mechanism takes into account the restrictions under Indian law on issuance of shares and tries to mitigate the effect of a down round issuance of shares to a third party. It requires the company to issue additional shares to the investor on a preferential allotment basis at the "lowest legally permissible price". Under Indian law, a foreign direct investor cannot be issued shares at a price that is lower than the DCF value. Therefore, the Indian company would have to issue shares at the lowest permissible price in order to give effect to the intended ratchet. While this method is legally

22. Section 79 of the Companies Act, 1956.
23. Recently, the pricing requirements were partially liberalized to permit freshly incorporated companies to issue shares at par to non-resident shareholders.
24. The press release dated August 16, 2012 issued by the SEBI discloses an intent to permit listed companies to reach the minimum public shareholding of 75% through bonus issuance. Implementation of this would require promoters to waive their right to receive shares in favour of other shareholders.
25. See Sections 205 and 78 of the Companies Act, 1956.
26. 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 the DCF Value.

sound and risk-free in terms of enforceability, it might not offer adequate commercial protection to the investor, because the lowest permissible price for a foreign investor (other than a FVCI) will be linked to the DCF Value of the company. In order to be issued the required number of shares the investor would then have to pay out this price.

However, in case of FVCIs registered with SEBI, the RBI has made a special exemption from the entry pricing norms[27] and therefore, FVCIs can be allotted shares at a price that is not lower than par value, making the enforcement of ratchet provisions considerably simpler.

- **Adjustable Conversion Prices / Conversion Formulas**

In the case of convertible preference shares or debentures it may be possible to adjust the conversion ratio such that the Investor receives more shares on conversion (for downside protection). However, the price of the equity shares to be issued on conversion, cannot be less than the DCF value of the shares of the Company as of the date of the investment. Therefore the number of additional shares that can be issued (upon conversion) remains limited. This does not usually pose a problem for FVCI entities for whom the pricing requirements do not apply.

- **Veto on Future Issuances**

Another way to provide downside (or general) 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.[28] 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.

c. Exit Options

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 important 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 legal and business environment, the investor's exit strategy needs to be adaptable and flexible to change. The following are, broadly speaking, the most common exit options available to offshore private equity and strategic investors:

i. IPO in India

In the event the Indian markets look promising and the investor feels comfortable with an exit on the Indian stock markets, the investor could exit after an IPO on the Indian stock markets. It must be noted however, that 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 provided that they have held these shares for a period of at least one year prior to the IPO. These entities can divest their holdings immediately after an IPO.

27. The Foreign Exchange Management (Transfer or Issue of Security by a Person Resident Outside India) Regulations, 2000
28. Certain 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.

ii. 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 liquidity on 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. It must be noted that such a listing would require an IPO on the Indian markets.

iii. Strategic Sale

The investor could also exit by way of a 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 the pricing requirements of the FI Regulations will apply. This 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, FVCI's are not bound by the pricing restrictions and can exit at a mutually agreed price. Further, pricing requirements do not apply to transfers between two non-resident persons.

iv. Drag-Along Rights

The investor may have a drag-along right, i.e. a right to 'drag' the promoters' shareholding while selling its own shares, to permit the buyer to buy all, or a larger chunk of the company. Drag-along rights are not often exercised as exit options and are generally reserved as the last resort for an exit by the investor. Often, drag-along rights are only made available to the investor in the event of a default or breach on the part of the promoters or the company.

v. Buyback / Put Options

The window of redeeming securities held by a foreign player in an Indian company was closed in 2007. Since then, it is common for an investor to seek alternate exit rights such as a 'buyback' right against the company or a 'put option' to the promoter. 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. For example: (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, (c) restrictions on the sources of funds for buyback etc. Put options have faced the ire of the authorities, with both the RBI and SEBI frowning upon the inclusion of put options in shareholders agreements. SEBI has specifically sought to treat put options as un-listed derivative futures contracts, which violate the Securities Contracts (Regulation) Act, 1956.

d. Corporate Governance

In most investment scenarios, the investor would be a minority shareholder in the company. From a corporate governance perspective (assuming low shareholding and proportionate board representation), the promoter would be able to control the company with ease at both the board and shareholder levels. The investor usually seeks board representation along with certain veto rights. The veto rights usually extend to matters relating to corporate governance (such as changes to board composition, amendments to the charter documents, related party transactions, mergers and acquisitions etc.) and certain high-level operational matters (such as entering into litigations, taking on loans, substantial sales of assets etc.).

An important question that arises relates to the conflict faced by investor nominee directors. Directors owe a fiduciary duty towards the company – to act in the interest of the company. However, investors require their nominee directors to act in the interest of the fund. This conflict results in nominee directors having to tread a thin line between the interests of the investor and the company. As a consequence, veto rights are often exercised directly by the investing entity rather than the nominee directors.

Directors face numerous other risks in relation to the operations of the company and can even be held criminally liable for the company's actions in some circumstances. It is therefore important for the nominee directors to ensure that they are sufficiently indemnified and that the company maintains an appropriate directors' and officers' liability insurance policy. The risk of a nominee director being liable will depend on his/her direct level of complicity in the relevant wrongdoing. In minor investments, an investor may also consider having a non-voting board observer rather than a director.

A further risk several foreign investors face is that of foreign anti-corruption laws, such as the Foreign Corrupt Practices Act, 1977 in the USA and the Bribery Act, 2010 in the UK. These laws have the potential to hold investor entities and employees liable in their home jurisdictions for corrupt activities that may take place in downstream entities.

Other typical rights negotiated in the documentation include reporting requirements and information rights, and the right to inspect the premises and books of the company.

VI. 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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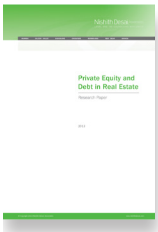

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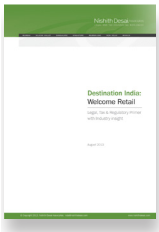

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