Dolly Goklaney

Subject: FW: Indian Venture Capital Association!
Attachments: SEBI- IVCA ANNEX-I- 261010.doc; SEBI- IVC ANNEX-II- 261010.doc; SEBI- IVCA ANNEX-3 261010.doc

From: Dolly Goklaney <president@indiavca.org>
Date: Fri, 29 Oct 2010 17:28:28 +0530
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Subject: Indian Venture Capital Association!

Mr Prashant Saran

Whole Time Member

Securities and Exchange Board of India

Exchange Plaza, "G" Block, 4th Floor

Bandra Kurla Complex, Bandra (E)

Mumbai- 400 051

Dear Sir,

Sub: Clarification on certain aspects of the Securities and Exchange Board of India (Venture Capital Funds) Regulations,1996 ('SEBI VCF Regulations')

We would like to bring to your attention a regulatory constraint faced by Venture Capital Funds ['VCF(s)'] seeking to invest in companies set up as holding companies, and operating in the infrastructure sector. The constraint mainly arises on account of the interplay of SEBI VCF Regulations and the regulations governing Non-Banking Finance Companies ('NBFC') issued by the Reserve Bank of India ('RBI'). This aspect has been discussed in detail in the ensuing paragraphs in the following manner:

Paragraph 1: Need for setting up holding companies in the infrastructure sector

Paragraph 2: Regulatory aspects and the uncertainty created by the interplay of SEBI VCF Regulations and the NBFC regulations

Paragraph 3: Specific clarification sought

Background

Typical structure

1.1 Holding company structures are commonly adopted for investments in the infrastructure sector. As the infrastructure sector usually carries high risks, to ring-fence assets and liabilities associated with each project, there is typically one holding company with multiple downstream investments in subsidiaries actually engaged in the development of various infrastructure projects.

1.2 This aspect was recognised by the Ashok Lahiri Committee, based on whose Report on Venture Capital (**'the Committee Report'**) the concept of 'Special Purpose Vehicles' was introduced in the SEBI VCF Regulations.

1.3 A diagrammatic representation of the typical structure in the infrastructure sector is provided in the **Annexure 1.**

1.4 'Infrastructure' is a key priority and a necessary condition for sustaining the growth of the Indian economy. The need for private investment, especially from VCFs, in infrastructure development is paramount. This aspect is emphasised further in **Annexure 2.**

1. **Regulatory aspects**

2.1 Under the SEBI VCF Regulations, a VCF is restricted from investing in a company engaged in rendering, *inter alia*, 'Non-banking financial services' (i.e. as per negative list specified in the Third Schedule to the SEBI VCF Regulations).

2.2 It is generally understood that this exclusion applies with respect to companies which (1) are engaged in the business of providing services <u>**and**</u> (2) are NBFCs registered with the RBI.

2.3 The RBI has recently introduced the regulatory framework ('CIC Framework') for governing Core Investment Companies ('CIC')[1]. CICs would now be expressly registered as NBFCs.

CICs are typically not engaged in rendering services. Hence, it should be possible for a VCF to invest in CICs engaged in investment holding activities, even if such entities are registered with the RBI as NBFCs.

2.4 These regulatory aspects and the uncertainty created by the interplay of SEBI VCF Regulations and the NBFC regulations are discussed in greater detail in **Annexure 3**.

2. **Request for clarification**

We would sincerely appreciate if you could clarify that holding companies investing in infrastructure projects would not be covered under the negative list specified in the Third Schedule to the SEBI VCF Regulations, even if such entities are registered with the RBI as CICs.

PricewaterhouseCoopers Private Limited ('PwC') is assisting us on this matter. We would like to seek an appointment to come and discuss this further with you. Please let us know when it would be convenient for you.

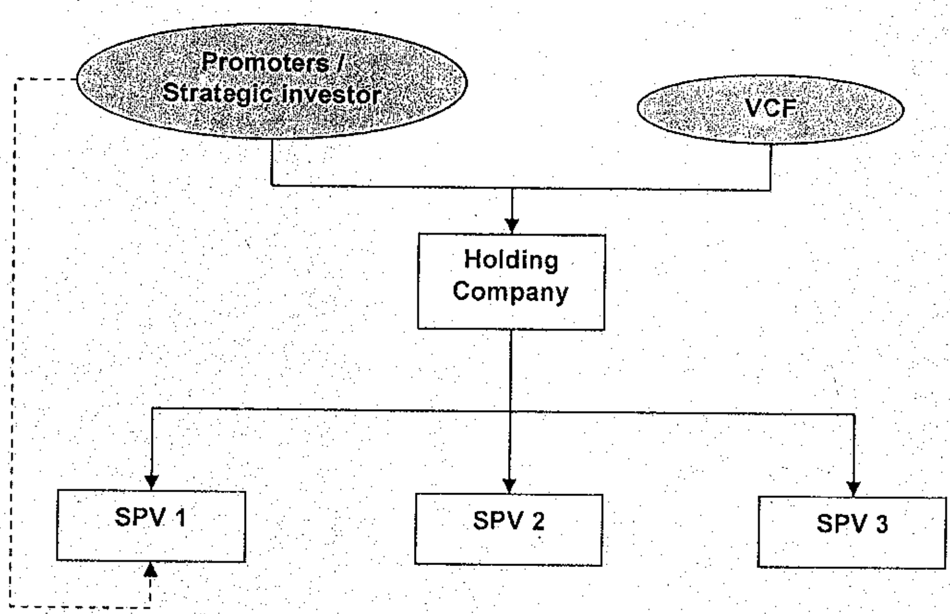
Yours sincerely,

Mahendra Swarup
President IVCA

[1] DNBS (PD) CC.No. 197/03.10.001/2010-11

Annexure 1

Typical structure adopted in the infrastructure sector



Annexure 2

<u>**Need for participation of the private sector in infrastructure investment**</u>

1. 'Infrastructure' is a key priority and a necessary condition for sustaining the growth momentum of the Indian economy.

2. The Planning Commission has emphasised that inclusive growth of the economy can be achieved only if the infrastructure deficit, both in terms of capacities as well as efficiencies in the delivery of critical infrastructure services, is overcome with the help of adequate investment in the infrastructure sector.

3. The Eleventh Five-Year Plan has set an ambitious target of increasing total investment in infrastructure from around 5% of Gross Domestic Product in the base year of the Plan (2006-07) to 9% by the terminal year (2011-12). In absolute terms, this implies an increase of investment requirement in the infrastructure sector from $ 222 billion in the Tenth Plan to $ 514 billion during the Eleventh Plan.

4. In March 2010, the Prime Minister, Dr. Manmohan Singh, once again stressed the role of the private sector in catalysing infrastructure investments and laid down a road map for planned investments of approximately US $1 trillion in the Twelfth Five-Year Plan.

5. Achieving the level of investment targeted by the Planning Commission will be possible only through active participation of the private sector in infrastructure investment. It is estimated that 30% of the total investment requirement will have to come from the private sector. Thus, creation of a supportive and investor-friendly environment is critical. Such private participation would not only provide much needed capital, but would also help to lower costs and improve efficiencies in a competitive environment.

Interplay of SEBI VCF Regulations and the NBFC regulations

SEBI VCF Regulations[1]

1. In terms of regulation 12(d) of the SEBI VCF Regulations, a VCF is required to invest as under:

   - at least 66.67% of its investible funds in unlisted equity shares or equity-linked instruments of a venture capital undertaking ('VCU') [Regulation 12(d)(i)];
   - not more than 33.33% of its investible funds, *inter alia*, in Special Purpose Vehicles ('SPV') created by the VCF for the purposes of facilitating investments in accordance with the SEBI VCF Regulations [Regulation 12(d)(ii)(e)].

2. Under the SEBI VCF Regulations, a VCU is defined[2] to exclude a company which is engaged in the activities or sectors which are specified in the negative list.

3. The negative list specified in the Third Schedule to the SEBI VCF Regulations includes, *inter alia*, 'Non-banking financial services'.

4. It is generally understood that this exclusion applies only to companies which are engaged in the business of providing services and are NBFCs registered with the RBI. NBFCs categorised as Equipment Leasing or Hire Purchase Companies are specifically excluded from the negative list.

5. It is also understood that the negative list ought not to apply to a VCF's investment in an SPV created for the purposes of facilitating investment in accordance with the SEBI VCF Regulations [as per Regulation 12(d)(ii)(e)], since the regulations expressly permit the possibility of investing in such companies.

RBI regulations governing NBFCs

6. CICs have been defined, under the CIC Framework, as follows:

   > *"A NBFC carrying on the business of acquisition of shares and securities which satisfied the following conditions:-*
   >
   > *(i) it holds not less than 90% of its Total Assets in the form of investment in equity shares, preference shares, debt or loans in group companies;*
   >
   > *(ii) its investments in the equity shares (including instruments compulsorily convertible into equity shares within a period not exceeding 10 years from the date of issue) in group companies constitutes not less than 60% of its Total Assets;*

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[1] The conditions under the **SEBI (Foreign Venture Capital Investors) Regulations, 2000** are similar.

[2] Venture Capital Undertaking means a domestic company:

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

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

(iii) *it does not trade in its investments in shares, debt or loans in group companies except through block sale for the purpose of dilution or disinvestment;*

(iv) *it does not carry on any other financial activity referred to in Section 45I(c) and 45I(f) of the RBI Act, 1934, except investment in bank deposits, money market instruments, government securities, loans to and investments in debt issuances of group companies or guarantees issued on behalf of group companies"*

7. In terms of section 45-I(f) of the Reserve Bank of India Act, 1934, an NBFC is defined[3], *inter alia*, to mean a 'financial institution' which is a company. The term 'financial institution' is defined[2], under section 45-I(c) of that Act to mean any non-banking institution which carries on as its business or part of its business, *inter alia, the acquisition of shares, stocks, bonds, debentures or securities issued by a Government or local authority or other marketable securities of a like nature.*

8. The RBI has mentioned, in the CIC Framework, that companies investing in shares of other companies, even for the purpose of holding stakes, would also be regarded as carrying on the business of acquisition of shares and hence be regarded as 'NBFCs'.

Interplay of SEBI and RBI regulations

9. Given that CICs would now be expressly registered as NBFCs, disputes could arise as to whether they fall under the negative list, under the SEBI VCF Regulations. In that case, it may not be possible for a VCF to invest in CICs engaged in investment holding activities under Regulation 12(d)(i) of the SEBI VCF Regulations.

10. Under Regulation 12(d)(ii), VCFs are permitted to invest not more than 33.33% of their investible funds in an SPV. The term 'SPV' has not been defined in the SEBI VCF Regulations. The Committee Report, pursuant to which regulation 12(d)(ii)(e) was introduced, describes SPVs as independent, stand-alone entities specifically set up for the purposes of a single transaction/ project.

The Committee Report further reads as follows:

> *"...there are several instances where VCFs/FVCIs need to resort to innovative financing structures by creating SPV in the form of Trusts or **holding companies that will house the shares of an underlying business."***
>
> *"....It was therefore requested that in order to make available a very valuable source of financing to corporate India, **investment vehicles** of the above nature*

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[3] Non-Banking Financial Company' means:

(i) a financial institution which is a company;

(ii) a non-banking institution which is a company and which has as its principal business the receiving of deposits, under any scheme or arrangement or in any other manner, or lending in any manner;

(iii) such other non-banking institution or class of such institutions, as the Bank may, with the previous approval of the Central Government and by notification in the Official Gazette, specify;

specifically incorporated for facilitating a transaction be allowed in the permitted list of investments for VCFs/FVCIs"

In view of the above, a CIC should be regarded as an SPV. Hence, it should be possible for a VCF to invest in a CIC under the 33.33% route.

However, for this purpose the SPV is required to be created by the VCF. Thus, it may not be possible for a VCF to invest in CICs not created by the VCF. Further, there is a limit on the amount that a VCF can invest in SPVs.

11. Furthermore, the rationale for specifying the negative list (specified in the Third Schedule to the SEBI VCF Regulations) was to restrict VCF investment in, *inter alia*, finance companies[4]. A CIC is an investment holding company set up primarily to hold investments for the long-term, and is not a *finance company*.

12. As mentioned earlier, the infrastructure sector usually carries high risks and, as a risk mitigation measure, separate operating companies are generally set up to undertake separate projects. Thus, CICs as an investment vehicle are prevalent in the infrastructure sector and, in fact, play a central role in the corporate structures created for investing in infrastructure.

13. In fact, the Committee Report specifically recommended exclusion of NBFCs categorised as Equipment Leasing or Hire Purchase Companies from the negative list to the Third Schedule on the basis that leasing transactions are common in the infrastructure sector, a sector that is engaged in asset creation and hence, a priority sector.

The Committee Report, on this aspect, states as follows:

> *"...many NBFIs are engaged in asset creation by financing assets as well as infrastructure projects such as roads, bridges, power and ports, either by granting direct loans to such projects or by providing lease finance for equipment."*

14. The Government of India has time and again emphasised the need for greater private sector investments in the infrastructure sector. VCFs play an important role in meeting the funding requirements of the private sector in the infrastructure space. Thus, VCFs have made significant investments in the infrastructure sector and will continue to do so in the future.

[4] As per the Report of K.B. Chandrashekhar Committee on Venture Capital