Foreign Venture Capital Investment(FVCI) Regulations

Recommendations for Further Development Critical Reforms Needed

Presentation to Ministry of Finance

IVCA
INDIAN PRIVATE EQUITY & VENTURE CAPITAL ASSOCIATION

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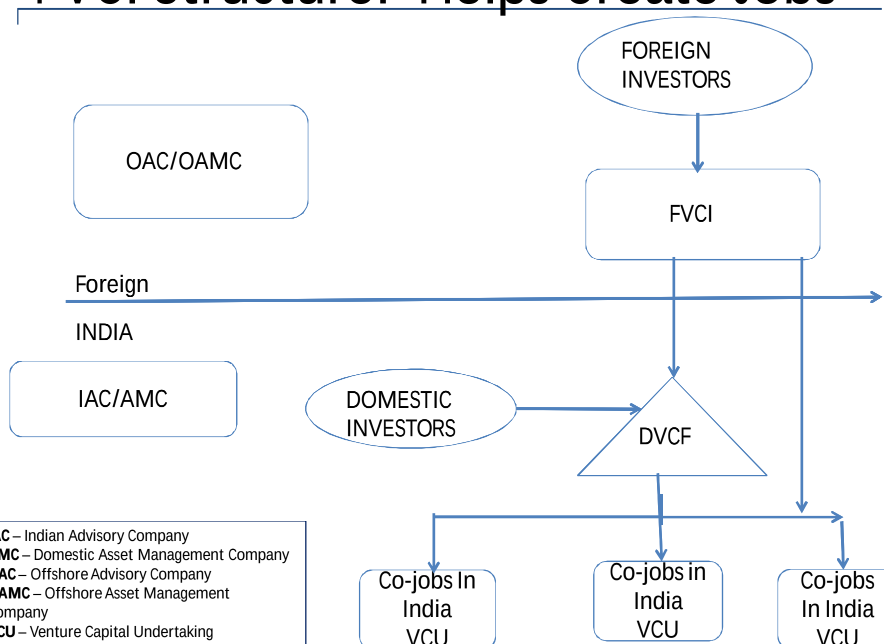
Need for Further Development

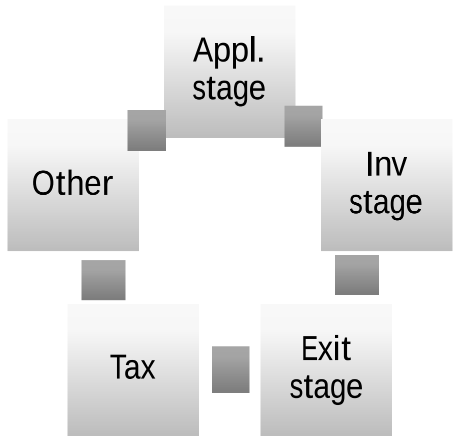
- Regulations were made 15 years ago and are outdated and need a revamp
- FVCI is stable long-term private equity and venture capital and can contribute to the development of a very wide range of sectors
- By providing capital to start-ups, growing or distressed companies, FVCI plays a critical role in creating jobs.
- FVCI reforms are the need of the hour to contribute to the Government's 'Make in India' program

FVCI Structure: Helps Create Jobs



IAC – Indian Advisory Company
AMC – Domestic Asset Management Company
OAC – Offshore Advisory Company
OAMC – Offshore Asset Management Company
VCU – Venture Capital Undertaking
DVCF – Domestic Venture Capital Fund

FVCI REGIME: AREAS WHERE CRITICAL REFORMS ARE REQUIRED



Background

- Securities and Exchange Board of India ('SEBI') introduced the SEBI (Foreign Venture Capital Investors) Regulations, 2000 on September 15, 2000
- Initially, approvals to FVCI granted by the RBI were blanket approvals (i.e. without any sector specific restrictions)
- Subsequently, in 2007, RBI has started issuing its approval to FVCI for investment in only certain specified sectors as specified in the provisions of the Income-tax Act, 1961 ('Income-tax Act')
- As on September 2014, there are 197 FVCIs registered with SEBI with a cumulative net investment of close to USD 8 billion

Application stage

i. Application for FVCI

- The processing of the application generally takes around 2-3 months which includes the processing time both at SEBI and RBI

Recommendation

a. Two step process of registration should be done away with

b. RBI should come up with general permission within which SEBI should be able to grant approval without the need to go for RBI approval

c. Can consider delegation of authority for granting the registration as is in the case with FPI's

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Investment stage ...

i. 10 sector investment restriction for FVCI

- Currently, RBI imposes restriction on the investments made by FVCI to select identified sectors

Recommendation

a. The restriction on investment to specific sector should be dropped

ii. Investment in AIFs

- FVCI is allowed to investment in AIF's after prior approval of FIPB

Recommendation

a. Investment by FVCI into AIFs set up as (Trust, LLP or Company) should be allowed without FIPB approval

iii. Investment in Optionally convertible instruments and debt

Recommendation

a. Specific notification to be issued that investment by FVCI in optionally convertible instruments and debt not qualify as ECB

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… Investment stage …

iv. Restriction on investment in listed securities

- Currently, FVCI can invest only 33.33% of its investible funds in listed equity shares

Recommendation

a. The restriction of 33.33% on investment in listed equity shares should be dropped

b. Permission to invest in other listed instruments should be granted

v. Investment at fixed IRR

Recommendation

a. Specific clarification to be issued that FVCI can have Put Option with fixed IRR

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… Investment stage

vi. Investment in warrants

Recommendation

a. Specific clarification to be issued that FVCI can invest in warrants for more than 1 year without paying 25% upfront

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Exits stage

i. Approval on transfer of securities to non-resident
   - Approval is required to be obtained from RBI at the time of sale of securities to non-residents

   Recommendations

   a. As FVCI are not governed by pricing guidelines, transfer of securities by FVCI should be allowed without approval so long as the transfer is at a price calculated at internationally accepted pricing methodology

ii. Remittance in case of transfer to non-residents

   Recommendation

   a. The requirement to remit sales proceeds to Indian bank account should be done away with in case FVCI transfers securities to a non-resident

Tax issues

i. Benefits similar to FPIs

   Recommendations

   a. MAT - Specific exemption for FVCI's from the provisions of MAT

   b. Tax deduction at source - Lower rate of TDS of 5% on interest income (Section 194LD) and NIL in case of capital gains (Section 196D)

   c. Definition of 'Capital asset' - To include securities held by FVCI

ii. Section 56(2)(viib) of Income-tax Act
   - Pricing guidelines do not apply to FVCI, however, issue at a value below FMV, could trigger tax implications for FVCI

   Recommendation

   a. Specific exemption to be provided in Income-tax Act for FVCI's to remove this anomaly

Tax issues: Removal of Hurdles to Basing Fund Managers in India

- Safe harbour for Manager / Advisor to FVCIs

  - The Manager, if any, to FVCI are outside India as they might get into a risk of creating a permanent establishment for the FVCI in India if the set-up in India

  - The Budget 2015, introduced safe harbour rules for Fund managers in India, however, the qualifying conditions are difficult to satisfy by the Fund Managers

Tax issues: Basing Fund Managers in India

- Finance Act, 2015 sought to encourage Fund Managers managing <u>eligible investment funds</u> to be based in India without being apprehensive of the POEM exposure, provided conditions mentioned in section 9A (ie. Safe Harbour) are satisfied

- Definition of eligible investment fund (Section 9A) is onerous which requires compliances with several conditions, key being :
  - o Minimum of twenty-five unconnected members
  - o No single investor (along with connected persons) holds more than 10% in the fund
  - o Ten or less members (along with their connected persons) hold less than 50% in the Fund
  - o Fund shall not carry on or control and manage, directly or indirectly, any business in India or from India

- Recently, it was clarified that some of the above conditions would not apply to investment funds set up by the Government or the Central Bank of a foreign State or a sovereign fund and to such other funds as the Central Government may by notification in the Official Gazette specify. However, there is no clarity yet in respect of PE Funds (which would also include FVCI investor entities)

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Tax issues: Basing FVCI Managers in India

- Recommendation

- Safe Harbour conditions (especially the 4 mentioned above) should not apply to "broad based funds" which have the meaning assigned under the Securities and Exchange Board of India (Foreign Portfolio Investors) Regulations, 2014.
- Further, the conditions should also not apply to funds that are registered under the Securities and Exchange Board of India (Foreign Venture Capital Investor) Regulations, 2000.
- This would provide the much required clarity / relief to fund managers managing such funds

Other issues

i. Negative List

Recommendation

a. To delete Non-banking financial Services from the negative list

Appendix

- 10 Sector restriction of RBI

  (i) Infrastructure
  (ii) Biotechnology
  (iii) IT related to hardware and software development
  (iv) Nanotechnology
  (v) Seed research and development
  (vi) Research and development of new chemical entities in pharma sector
  (vii) Dairy industry
  (viii) Poultry industry
  (ix) Production of bio-fuels
  (x) Hotel-cum-convention centres with seating capacity of more than 3,000

Thank You

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