

## Real Estate Laws

Foreign entities cannot engage in real estate business in India. The only permissible transaction involving real estate is where the non-resident party carries out development of a minimum area with a committed minimum investment. There is no restriction though, on acquiring real estate for business activities of the entity. A real estate regulation and development bill has been approved by the cabinet, but is yet to receive the approval of the two houses of parliament. The bill is intended to protect the interest of consumers and sale of immovable properties in an efficient and transparent manner. There is also no concept of title insurance in India.

## Securities Laws

Securities laws largely govern transactions in securities that are listed on stock exchanges in India. Compliance is dependent on the nature of the transaction. One instance that would trigger a disclosure by the acquirer is where there is acquisition of shares or voting rights beyond a specified threshold. In addition, acquisitions beyond certain thresholds could require the acquirer to make open offers to also purchase shares from the public shareholders of the target company.

## Arbitration Laws

Arbitration as an alternate dispute resolution mechanism seeks to address the issues surrounding litigation in courts. Contracts typically contain arbitration as the dispute resolution mechanism, with the procedure for arbitration framed by LCIA, SIAC or the ICC. India is also a party to the Geneva and New York conventions to facilitate enforcement of foreign arbitral awards. Pursuant to recent judgments by the Supreme Court of India, the seat of arbitration is also a key consideration to be borne in mind.

An understanding and familiarity with these laws will go a long way in taking appropriate decisions for a successful investment.

# New Platform for SMEs in India to Provide a Tax Efficient Exit for Investors

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## Introduction

As will be the case for most of the growing economies, small and medium enterprises (“SMEs”) in India too hold an integral position for the upliftment of the social and economic growth of the nation. In India, SMEs account for approximately 8% of the gross domestic product (GDP), 50% of total manufactured exports and 45% of industrial employment (with around 55% of the workforce from rural areas).<sup>4</sup>

Realising the strategic importance of SMEs, Indian government has been forthcoming in providing an enabling environment for these SMEs to flourish by implementing policies so as to provide them easy access to credit facilities, imposing obligations on foreign retailers in India to source goods from SMEs, and setting up a separate SME exchange dedicated to this segment.

However, despite the impetus, the SME sector in India has been facing several challenges in raising adequate equity financing and importantly gaining visibility. The difficulty can be attributed to the following factors: (i) high cost of due diligence as compared to the small deal size, hence, skewed ratio for the cost of investment and the returns therein; (ii) lack of credible data for diligence; (iii) high failure rate of start-ups; (iv) limited options with the investor to exit the company; (v) high cost and long duration for enforcing any security (like mortgage / pledge) in India; and (vi) difficulty in making an IPO under the existing framework.

Since the SME segment houses the potential energy which can propel any economy, even a developed jurisdiction like the United States of America has been forthcoming in adapting to the needs of the start-ups as it rolled out the Jumpstart Our Business Startups Act (**JOBS Act**) on April 5, 2012. The JOBS Act aims to provide easy market access to companies which have total revenues less than US Dollar 1 billion in its most recently completed fiscal year (known as the emerging growth company

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<sup>4</sup> Annual Report 2012-2013, Government of India; Ministry of Micro, Small and Medium Enterprises.

(EGC)). To suit the needs of the SME segment in the USA, the JOBS Act, provided regulatory relaxations to these EGCs while allowing them to keep their business financials confidential in the process of listing, which proved to be critical and has provided several successful listings in the past two years.

In line with the global standards, besides the existing framework for listing of SMEs on the SME exchanges (“**SME Exchanges**”) that have been floated by the leading exchanges in India, i.e., National Stock Exchange (“**NSE**”) and the Bombay Stock Exchange (“**BSE**”), recently, in a significant move, a new framework for listing of SMEs has been introduced by the Securities and Exchange Board of India (“**SEBI**”) known as the Institutional Trading Platform (“**ITP**”) to encourage institutional investors to invest in SMEs.

This paper outlines the following: (i) the prevalent framework for listing of SMEs on the SME Exchange and the constraints; (ii) the newly introduced framework for listing of SMEs on the ITP; and (iii) benefits that the ITP may ensue for the Indian SMEs and the venture capitalists looking to invest in the SME segment.

## Prevalent Framework of SME Exchange

Chapter XB of the SEBI (Issue of Capital and Disclosure Requirements) Regulations, 2009 (“**ICDR Regulations**”) provides for issuance of specified securities by SMEs on SME Exchange.<sup>5</sup> Broadly, an SME was required to make an initial public offering (“**IPO**”) without having to file the draft offer document with SEBI. Although, criteria which were otherwise applicable for listing of companies on the SME Exchange, like minimum net worth, profitability and tangible assets, etc., were waived, onerous conditions—such as requirement for promoters to dilute 25% of their stake, compulsory market making for 3 (three) years and underwriting 100% of the issue, with the merchant banker himself underwriting directly up to 15% of issue size—still remain.

These factors, in addition to the additional qualifications that were introduced independently by the NSE and the BSE like profitable track record in 2 (two) out of the last 3 (three) years or positive accruals for the last 3 (three) years, significantly discouraged the issuers from going public on the SME Exchange and made way for certain profitable and already flourishing SMEs to list on the SME Exchange. This is also substantiated by the fact that in the past 2 (two) years only 55 companies have listed on the SME Exchange of BSE.<sup>6</sup>

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<sup>5</sup> Regulation 106N(1)(c) of the ICDR Regulations defines “SME exchange” as a trading platform of a recognized stock exchange having nationwide trading terminals permitted by SEBI to list the specified securities issued in accordance with Chapter XB of the ICDR Regulations and includes a stock exchange granted recognition for this purpose but does not include the Main Board. Regulation 106N(1)(a) of the ICDR Regulations defines “Main Board” as a recognized stock exchange having nationwide trading terminals, other than SME exchange. Regulation 2(i)(zj) of the ICDR Regulations defines “specified securities” as equity shares and convertible securities.

## Evolution of the ITP Regulations

Considering the larger interest of the SME sector, the Finance Minister of India had announced earlier in 2013 that a new set of regulations shall be framed by SEBI for allowing listing of start-ups and SMEs without an obligation for them to undertake an IPO. Taking a cue from this, the Indian securities regulator, SEBI, notified the SEBI (Listing of Specified Securities on Institutional Trading Platform) Regulations, 2013 (“**ITP Regulations**”) <sup>7</sup>, which was made a part of the ICDR Regulations as a new Chapter XC.

The ITP Regulations are aimed at providing a platform and visibility to various start-ups and SMEs and also provides them greater fund raising capabilities. It also provides a wider investor base to such SMEs and acts as a platform for the existing investors to exit efficiently from their investments into such start-ups and SMEs.

## Salient Features of the ITP Regulations

SME is defined under the ITP Regulations to mean a public company including start-up company, that complies with all the prescribed eligibility conditions. Such SMEs may list on the ITP without having to comply with the requirements for listing of securities on a recognized stock exchange under rule 19(2) (b) and 19(7) of the Securities Contract (Regulation) Rules, 1957. Hence, listing of specified securities (which is defined to mean equity shares and convertible securities) on the ITP can be achieved without an IPO and at substantially low costs compared to a listing on the main exchange or even the SME Exchange.

Under the ITP Regulations, the requirements of compulsory market making and underwriting are removed by ensuring that retail investors do not participate in this exchange. This is attempted to be achieved by increasing the minimum trading lot in ITP to INR 1,000,000 (Rupees One Million).

However, the ease of listing for an SME on the ITP comes with certain checks and balances in an attempt to hit the right balance between attracting such SMEs to approach the platform and the risk for the informed investors willing to risk their monies into these SMEs. Accordingly, it is provided under the ITP Regulations that for an SME to be eligible to list its specified securities on the ITP, the following requirements should be satisfied:

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<sup>6</sup> Information available on <http://www.bsesme.com/#markets>, last visited on April 3, 2014.

<sup>7</sup> The ITP Regulations are available here: [http://www.sebi.gov.in/cms/sebi\\_data/attachdocs/1381311146097.pdf](http://www.sebi.gov.in/cms/sebi_data/attachdocs/1381311146097.pdf), last visited on April 3, 2014.

<sup>8</sup> Due to notification of the Companies Act, 2013, section 2(72) of the Companies Act, 2013 has replaced section 4A of the Companies Act, 1956.

- a. Existence criteria: The SME should have at least 1 (one) full year's audited financial statements for the immediately preceding financial year and should not have completed a period of more than 10 (ten) years since its incorporation;
- b. Past conduct criteria: The promoters, directors or group company of the SME and the SME itself should not be in the list of wilful defaulters of the Reserve Bank of India ("RBI"). No winding up petition against the SME should have been admitted by a competent court. The group of companies or subsidiaries of the SME and the SME itself should not have been referred to the Board for Industrial and Financial Reconstruction within a period of 5 (five) years prior to the date of application. Also, no regulatory action shall have been taken against the SME, its promoter or directors, by SEBI, RBI, Insurance Regulatory and Development Authority or Ministry of Corporate Affairs within a period of 5 (five) years prior to the date of application;
- c. Financial criteria: The revenue of the SME should not exceed INR 1,000,000,000 (Rupees One Billion Only) in any of the previous financial years and the paid-up capital of the SME should not exceed INR 250,000,000 (Rupees Two Hundred Fifty Million Only) in any of the previous financial years; and
- d. Past funding criteria: A SME willing to list on the ITP is required to meet any one of the following criteria – (i) at least one alternative investment fund, venture capital fund or other category of investors / lenders approved by SEBI should have invested a minimum amount of INR 5,000,000 (Rupees Five Million) in its equity shares; (ii) at least one angel investor who is a member of an association or group of angel investors should have invested a minimum amount of INR 5,000,000 (Rupees Five Million) in its equity shares; (iii) the SME should have received finance from a scheduled bank for its project financing or working capital requirements and a period of 3 (three) years should have passed from the date of such financing and the funds so received have been fully utilized; (iv) a registered merchant banker should have exercised due diligence and has invested not less than INR 5,000,000 (Rupees Five Million) in its equity shares which shall be locked in for a period of 3 (three) years from the date of listing; (v) a qualified institutional buyer should have invested not less than INR 5,000,000 (Rupees Five Million) in its equity shares which shall be locked in for a period of 3 (three) years from the date of listing; or (vi) a specialized international multilateral agency or domestic agency or a public financial institution as defined under section 4A of the Companies Act, 1956<sup>9</sup> must have invested in its equity capital.

## Listing on the ITP

An eligible SME can list on the ITP by filing an information document containing certain prescribed disclosures relating to, inter alia, description of business, specified financial information (including audited balance sheet, profit & loss account, cash flow statement, with attendant annexure and notes to accounts for the previous year), risk factors, assets and properties, ownership of beneficial owners, details of directors, executive officers, promoters and legal proceedings. It must be noted that, in order not to challenge the qualms of a number of entrepreneurs of start-ups and SMEs, the threshold of disclosures required to be made by a company approaching the ITP is much lower than as applicable to an issuer proposing to list on the Main Board. Once the stock exchange provides its approval, the specified securities of the SME can be listed on the ITP of the particular stock exchange.

The ITP Regulations require at least 20% of the post listing capital to be held by the promoters of the SME which shall be locked-in for a period of 3 (three) years from the date of listing on the ITP.

## Restrictions on Further Issue of Securities

Listing of specified securities on the ITP cannot be accompanied by any issue of securities to the public in any manner. Further, the SME cannot undertake an IPO while its specified securities are listed on the ITP. In order to do so, the company will need to delist itself from the ITP.

## Capital Raise by an SME Listed on ITP

An SME listed on the ITP may raise capital through private placement or rights issue to its shareholders without providing them an option to renounce their rights in favour of a third party. Before raising capital through private placement, amongst other stipulated conditions, SME should procure an in-principle approval from the relevant stock exchange and also a shareholders approval by special resolution and subsequently the allotment of securities has to be completed within 2 (two) months of obtaining such approvals. Such an in-principle approval from the stock exchange is also required prior to a rights issue.

## Exit from the ITP: When and How?

An SME listed on the ITP may voluntarily exit from the platform if its shareholders approve such exit by passing a special resolution where 90% of total votes and the majority of non-promoter votes are casted in favour of such proposal or if the recognised stock exchange, where its shares are listed, approves such exit.

Further, an SME listed on the ITP shall exit from it if: (i) the specified securities have been listed on ITP for a period of 10 (ten) years; (ii) the SME has paid-up capital of more than INR 250,000,000 (Rupees Two Hundred Fifty Million); (iii) the SME has revenue of more than INR 3,000,000,000 (Rupees Three Billion) as per the last audited financial statement; or (iv) the SME has market capitalization of more than INR 5,000,000,000 (Rupees Five Billion). The stock exchange may grant 18 (eighteen) months' time period to the SME to delist from the platform on occurrence of the events specified in this paragraph.

## **Non-applicability of the Takeover Code and Delisting Regulations**

One of the key advantages for a company that is listed on the ITP is that the ITP Regulations expressly provide that the SEBI (Substantial Acquisition of Shares and Takeovers) Regulations, 2011 ("**Takeover Code**") would not be applicable to any direct and indirect acquisition of shares or voting rights in, or control over, a company listed on the ITP of a recognised stock exchange. Similarly, the SEBI (Delisting of Equity Shares) Regulations, 2009 ("**Delisting Regulations**") shall also not apply to securities listed on the ITP of a recognised stock exchange. This relaxation is a prudent move and will help the companies that list on the ITP with respect to their ease of operation and towards achievement of their strategic initiatives.

## **Tax Efficiency for the Investors**

The tax benefit available to the investors at the time of their exit from securities listed on the ITP should be as is applicable in case of securities listed on traditional market platforms. There should be no long-term capital gains tax payable on transactions executed on the floor of the stock exchange on which Securities Transaction Tax (**STT**) has been paid. Short term capital gains on transactions executed on the floor of the stock exchange should be taxed at the prevailing rate for other listed securities, provided that STT is paid on such transaction. Thus, listing on the ITP can also become an attractive mode for an efficient exit by the venture capitalists and angel investors who may have infused growth capital in the SMEs.

## **The Beginning**

The ITP Regulations should go a long way in providing the necessary stimulus in the growth of SMEs in India. The new platform should aid SMEs in getting access to capital as well as wider visibility. As the mode of exiting from the platform is also relatively simplified, the migration to the main exchange would possibly be much smoother for a company whose specified securities are listed on the ITP of a recognised stock exchange. Further, this will help in fostering innovation in the country and help in risk diversification for the entrepreneurs.

As SEBI had indicated in its board meeting of June 25, 2013, the ITP Regulations are framed with the intention of allowing easier exit options for the informed investors who risk their capital to support SMEs. Non-applicability of certain onerous conditions, as in case of listing under Chapter XB of the ICDR Regulations or with respect to listing on the Main Board, will encourage a number of SMEs to explore the option of getting their specified securities listed on the ITP. This platform will certainly see some action in the near future due to encouraging aspects such as no requirement to conduct an IPO, no restriction from raising further capital by private placement or rights issue and non-applicability of Takeover Code and Delisting Regulations. Over and above these, investors will benefit from the ITP Regulations with the certainty in taxation and the ease in monitoring of the listed portfolio due to reporting and compliance requirements of a regulated trading platform.

