Corpsec Hotline

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VENTURE CAPITAL FUNDS: TAKING AN OFFSHORE FLIGHT WITH CLIPPED WINGS

With the growth in size and sophistication of the private equity industry in India, domestic players have felt the need to invest globally. Further, in the recent past, there have been instances where domestic VCFs would have benefited from participating in VCUs which had operations in India, however, due to lack of any guidelines with respect to the same, these potential benefits could not be enjoyed.

The Securities and Exchange Board of India ("**SEBI**") in response has enacted new regulations allowing domestic private equity players to make cross border investments, albeit with certain conditions.

Vide its amendment to the SEBI (Venture Capital Funds) Regulations, 1996 ("**Regulations**") introduced in the year 2006, in the form of insertion of Regulation 12 (ba), investment in securities of foreign companies was envisaged subject to conditions or guidelines that were yet to be stipulated or issued by the Reserve Bank of India ("**RBI**") and the SEBI from time to time. Thus, although the Regulations provided for the enabling provision with respect to VCFs being permitted to invest in securities of foreign companies abroad, the operational mechanism for the same was pending. It may be noted that RBI had on April 30, 2007, in consultation with SEBI, permitted VCFs to invest abroad in equity and equity linked instruments upto a ceiling of USD 500 million. RBI had also subsequently clarified that once SEBI's approval was obtained, no separate RBI approval would be required for the offshore investments.

On August 9, 2007, SEBI brought fruition to the needs of the domestic private equity players by finally introducing the norms for investments overseas.

Under the circular dated August 09, 2007 (Circular), SEBI has enlisted the following conditions for registered VCFs desirous of making investments in offshore Venture Capital Undertakings ("**VCUs**"):

- Total investment limit in offshore Venture Capital Undertakings ("**VCUs"**) is capped at US$ 500 million to invest in equity and equity linked instruments only. An Offshore VCU would mean a foreign company whose shares are not listed on any of the stock exchanges in India or abroad. The allocation of investment limits would be done on 'first come- first serve' basis, depending on the availability within the overall limit of US$ 500 million. Application for allocation for further investment limit shall be by way of a fresh application;
- Investments can be made only in those companies which have an Indian connection (i.e. companies which have front offices overseas, while the back office operations are in India);
- Such investments can be upto 10% of the investible funds of the VCF;
- Investments need to be made within 6 months, if not made; SEBI can re-allocate the unutilized investment limit to other applicants; and
- No separate RBI approval is required after SEBI approval is given.

While these much awaited guidelines will see VCFs queuing up to get their quota of the US$ 500 million pie, the guidelines are surely restrictive in nature. For example, VCFs will be only permitted to make investments in equity or equity linked instruments of these offshore VCUs. Thus, they may not be permitted to make debt investments, or even participate in offshore IPOs of these VCUs.

Further, the offshore VCU must have an Indian connection, and a technical reading of the guidelines provides for investment only in offshore VCUs which have outsourcing units in India. Thus, the guidelines may not permit investment into offshore VCUs which do not have a back office in India, but may nonetheless have an Indian connection by way of other business operations, like manufacturing units, etc. Further, by providing a front office-back office relationship, a technical interpretation of the guidelines may also mean that the VCFs may not be able to invest in foreign companies, who outsource a substantial portion of their operations to Indian companies, but do not have a "back office" in India. Maybe SEBI should have considered not imposing such a strict parameter, but alternatively could have linked the investment eligibility to certain other parameters which would create value in India, like percentage of operational expenses in India, supply chain in India, etc.

As per these guidelines, the offshore investment by VCFs has been restricted to upto 10% of their investible funds. The definition of investible funds has been provided in the Regulations to mean the corpus of the fund net of expenses. While the industry had been demanding a higher limit in this regard, SEBI has not really adhered to the demands of the industry, and has instead restricted the investment to 10%.

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Thus, while SEBI has provided the first step for overseas investments, SEBI may consider liberalizing and relaxing them in due course of time, and give more flexibility to domestic players, considering the restrictive reach of the guidelines. Meanwhile, considering the recent change in the tax laws which diluted the benefits of SEBI registration, this step may act as an incentive for domestic funds to get registered with SEBI considering the fact that unregistered funds may not be permitted to invest abroad.

Source: SEBI/VCF/Cir.no 1/98645/2007

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You can direct your queries or comments to the authors

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