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Get the foreign venture capital regime back on track

Regulatory delays in clearing applications are causing anxiety among foreign VC funds, say Richie Sancheti & Vikram Shroff

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RECENT news reports indicate that the Reserve Bank of India (RBI) would like to limit investments by Sebi-registered foreign venture capital investors (FVCIs) to certain select sectors.

Apparently, RBI has written to the ministry of finance recommending interalia that investments by FVCIs be restricted to nine sectors to encourage development of entrepreneurial capabilities. RBI has been uncomfortable with FVCIs having low-capital base, circumventing takeover guidelines and round-tripping of investments, and has therefore also suggested that Sebi set up screening mechanism for all FVCI applications. In the interim, most of the applications have been kept on hold without any clarity on the time frame.

The intention behind introducing the FVCI regime in 2000 was to provide FVCIs a favourable environment with respect to their investments in India compared with foreign direct investment (FDI) and create a level-playing field between domestic and overseas venture funds. FVCIs are accordingly entitled to certain benefits, including exemption from entry and exit pricing norms, exemption from any lock-up restriction, post-IPO (subject to certain conditions), and exemption from applicability of the takeover code in the event of sale of shares back to Indian promoters (and not generally). RBI seems to have developed some concerns on the nature of the applications received and investments under the FVCI regulations. Below are some of these concerns with our views.

Low Capital Base:

RBI is apparently uncomfortable with FVCI applicants having a low-capital base. The industry practice of venture capital (VC) and private equity (PE) funds has been that they typically solicit capital commitments from investors and make drawdowns as and when there are investment opportunities. Further, the FVCI registration fee is $25,000 which would be paid only if substantial investments are likely to be made. If necessary, the FVCI regulations should stipulate the minimum capital base.

Real Estate Investments:

FVCI regulations were amended in 2004 to exclude ‘real estate’ from the negative list. This allowed FVCIs to invest in the real estate. However, RBI’s view was that real estate investment should not be considered as venture capital investment. One could appreciate RBI’s concern arising out of spiralling real estate prices in recent times. RBI has been requiring an undertaking from applicants that they shall not invest in real estate, and to our understanding, has not cleared any real estate focused FVCI applications.

Regulatory Arbitrage:

RBI believes that the FVCI route may leave scope for regulatory arbitrage vis-`-vis direct investments. If this was indeed the concern against suspending the registrations, RBI could deal with these concerns through other means such as a possible lock-up of one year on transfer of shares or specifically restricting intra-group transfers without prior approval at a price which is less than the FMV/NAV.

Compliance with FDI Policy and Round-tripping:

RBI has asserted that FVCI entities do not comply with FDI policy and certain investors resort to roundtripping. Regarding FDI policy, RBI in its approval letter, provides that the FVCI is required to comply with the FDI policy. Such a provision seems sufficient to address this concern. With respect to round-tripping, we believe that it should not be construed as an illegal activity as long as it is not prohibited under law and funds flow through proper banking channels. In fact, most investment flows into India under FVCI route are from reputed investors including pension fund corpuses, endowment and sovereign funds, HNIs, etc. Jurisdictions like Mauritius have been strict especially with their KYC requirements. Financial Services Commission, Mauritius has issued stringent norms to local administrators to require regulatory approvals, legal opinions, etc. in case of Indian individuals investing in Mauritius.

Use of Tax-Favourable Jurisdictions:

RBI seems concerned from the fact that several FVCI applicants are based in tax-favourable jurisdictions. The validity of using Mauritius as a holding company jurisdiction, where investors from different jurisdictions pull together their investments in but ultimately pay tax in their home jurisdiction, has been well settled in the apex court’s landmark ruling in Azadi Bachao Andolan case.

International investors are generally more comfortable in using treaty jurisdictions to invest in India, since it brings more certainty in tax matters. The uncertainty of the regulators on the FVCI regime leading to delay in clearing applications is sending out negative signals to potential foreign investors. The regulators need to resolve the issues as soon as possible and get the FVCI regime back on its track. **(The authors work for Nishith Desai Associates)**