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HNIs seek SAFE passage to startup valley

By Sugata Ghosh, ET Bureau • Last Updated: Feb 13, 2023, 06:28 AM IST

Synopsis
SAFE, standing for 'simple agreement for future equity', is a quasi-debt and a promise to let the investor hold stocks or preference shares some years later on the startup achieving certain milestones. Thus, unlike plain vanilla convertibles, a SAFE note is not necessarily converted into equity, and may well remain as a debt in the books of a startup.

Also, under the old rules, resident Indians were allowed to retain LRS proceeds in an overseas bank account.

Mumbai: Wealthy Indians, betting on Silicon Valley startups, have sent out feelers to the Reserve Bank of India (RBI), to lift the ban on offshore investments in 'SAFE notes' - a popular instrument floated by new ventures to raise money without diluting the equity of founders.

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Wealthy Indians invest abroad under the central bank's Liberalised Remittance Scheme (LRS), which allows a resident individual to buy up to $250,000 in overseas stocks, bonds, mutual funds, and properties every year. However, the new dos and don'ts introduced last year by RBI in the LRS regulation prevent investment in hybrid papers like SAFE which are typically not listed in a stock exchange.

Agencies

Early Stage Opportunity

- A 'SAFE note' is a promise to offer equity under certain conditions
- These are unlisted papers, not mandatorily converted into stocks
- In markets like the US, startups issue SAFE to raise seed capital
- New rules have dos & don'ts on investment in foreign unlisted debt

"Under SAFE an investor can purchase a specified number of shares for an agreed-upon price at some point in the future. As an instrument, it's frequently used to raise initial seed funding and many Indians think this may be a good time to invest from a future gain perspective...But, the revised rules do not permit such investment under the LRS Scheme. This does impact the

opportunity available to Indian HNIs as at the initial stages most overseas startup founders would not be keen to impact their cap tables," said Moin Ladha, partner at the law firm Khaitan & Co.

Some of the wealth managers and finance professionals representing local HNI investors have drawn the attention of senior officials of authorised dealer banks, which handle the remittance of funds under LRS, as well as regulatory officials.

A startup which issues the SAFE notes may also buy them back when the next round of funding comes. So, upon non-conversion or buyback, it takes the flavour of a debt. And the revised LRS rules spell out that a resident individual can take exposure to overseas unlisted shares of debt of an entity under the overseas direct investment (ODI) route only if the person has at least 10% control in the foreign investee company.

But a predominant number of HNIs looking for a slice of the action from their bets on offshore securities, have no intention of owning as much as 10% or any sizeable stake in a company. They either invest in notes like SAFE to catch any possible upside in the story or put money in regulator-listed securities like shares, bonds, and units of mutual funds. "Unlike in the past, the new LRS rules make it clear where you can and cannot invest. For unlisted securities, an HNI has to take the ODI route, while for listed ones it's the portfolio route of the LRS. There are certain grey areas, as it's unclear whether one can hold fixed deposits with a bank abroad. We are waiting for a FAQ from the RBI," said a banker.

"Under the current regime, ODI can be made, inter alia, in equity capital which includes contribution to non-debt capital of a foreign entity in the nature of fully and compulsorily convertible instruments. Thus, investability into SAFE, which is a convertible equity instrument, should depend upon the terms and conditions of its issuance. To the extent the instrument is not fully and compulsorily convertible into equity, investment into it by a resident Indian individual might be an issue," said Prakhar Dua, leader, financial services and regulatory practice at Nishith Desai Associates.

Even in specific investments where RBI has a strong view the regulator has not made things unambiguously clear. For instance, a few years ago, some of the private sector banks added a line in the LRS form, seeking a declaration from the resident investor that the money remitted cannot be used to trade on cryptocurrencies.

Also, under the old rules, resident Indians were allowed to retain LRS proceeds in an overseas bank account. But, they are now required to repatriate realised foreign exchange within 180 days, unless reinvested in accordance with the new overseas investment rules. The reason for this change seems to be to discourage the accumulation and flight of uninvested Indian capital outside the country. This is also evident with the FY24 Union Budget proposing to raise the tax collection at source (TCS NSE -1.56 %) to as high as 20% from 5% on foreign remittances.

"So for remitting $10,000 under LRS, a person has to pay the rupee equivalent

of $2,000 to the government and adjust the TCS while paying advance tax. If the advance tax is not large enough, he has to claim a refund from the income tax department. These are nothing but ways to discourage foreign investment," said another person.