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Foreign Venture Capital Investors See Investment Opportunities Expanded

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The Reserve Bank of India ("RBI"), with RBI/2011-12/452/A.P. (DIR Series) Circular No. 93 dated March 19, 2012 ("Circular"), has allowed Securities and Exchange Board of India ("SEBI") registered foreign venture capital investors ("FVCIs") to invest in eligible securities (equities, equity linked instruments, debt, debt instruments, debentures of a venture capital undertaking or a venture capital fund, and units of schemes/funds set up by a venture capital fund) by way of private arrangement or purchase from a third party.

The RBI has also clarified through the Circular that FVCIs will be allowed to invest in securities on a recognized stock exchange, subject to the provisions of the SEBI (FVCI) Regulations, 2000, as amended from time to time ("FVCI Regulations").

Background

Until recently, on account of the duality of the regulators (SEBI and the RBI) in respect of FVCIs, which are licensed by both these authorities, there was ambiguity on two counts for FVCIs: first, the ability of FVCIs to purchase existing shares from existing investors/shareholders under the FVCI route, as against the fresh issuance of new shares by an Indian venture capital undertaking, which was clearly permitted, and second, whether FVCIs can make investments in listed securities which are permitted under the FVCI Regulations.

While there was no specific restriction under the FVCI Regulations in respect of the purchase of existing shares from existing investors, based on certain informal guidance issued by the RBI to certain custodian banks, they did not permit their FVCI clients to purchase secondary shares of an Indian venture capital undertaking by way of private arrangement with third parties. In fact, after much confusion on the issue, this view of the custodians was endorsed by the RBI in RBI/2011-12/15/Master Circular No. 15/2011-12 dated July 1, 2011, stating that FVCIs cannot acquire securities by way of a private arrangement with a third party. This specific restriction, combined with the sectoral restrictions on investments by FVCIs, also imposed by the RBI, significantly curbed the investment flexibility available to FVCIs and the entire utility of this regime to a great extent.

Further, in respect of an FVCI's ability to invest in listed securities, it may be noted that, under the conditions on which RBI approvals were granted to FVCIs, and based on the reading of Schedule 6 of the Foreign Exchange Management (Transfer or issue of security by a person resident outside India) Regulations, 2000 (Notification No. FEMA 20/2000 -RB dated May 3, 2000) ("TISPRO"), there was no explicit permission available to FVCIs to make investments in listed securities, since investments by FVCIs were permitted only in venture capital funds and Indian venture capital undertakings, which were defined to mean companies which are not listed on a recognized stock exchange. (As per Regulation 2 (va), TISPRO, venture capital fund means a fund established in the form of a trust, a company including a body corporate and registered under the Securities and Exchange Board of India (Venture Capital Fund) Regulations, 1996 which has a dedicated pool of capital raised in a manner specified under the said Regulations and which invests in venture capital undertakings in accordance with the said Regulations. As per

Regulation 2 (va), TISPRO, (Indian) venture capital undertaking means a company incorporated in India whose shares are not listed on a recognized stock exchange in India and which is not engaged in an activity under the negative list specified by SEBI.)

On the other hand, the FVCI Regulations permitted FVCIs to invest 33.33 percent of their investible funds in, *inter alia*, 1) preferential allotments of equity shares of a listed company subject to a lock-in period of one year; 2) subscription to an initial public offer of an Indian venture capital undertaking whose shares are proposed to be listed; and 3) equity shares or equity linked instruments of a financially weak company or a sick industrial company (as defined under Explanation to Regulation 12(d)(ii)(d) of the FVCI Regulations) whose shares are listed.

The Circular

With the issuance of the Circular, FVCIs have now been allowed by the RBI to invest in eligible securities by way of private arrangement or purchase from a third party, subject to terms and conditions as stipulated in Schedule 6 of TISPRO as amended from time to time. Schedule 6 of TISPRO lays down the criteria in respect of the purchase of eligible securities, the opening and maintenance of bank accounts, the valuation of investments, *etc.*, based on which FVCIs can make investments in India.

The cloud of ambiguity pertaining to FVCIs being allowed to invest in listed securities has also been cleared. It has been clarified by the RBI through the Circular that FVCIs are permitted to invest in securities on a recognized stock exchange, subject to the provisions of the FVCI Regulations as well as the terms and conditions stipulated therein.

Analysis

Clearly the Circular stipulates that, henceforth, FVCIs shall be permitted to undertake secondary purchase of shares in an Indian venture capital undertaking from existing shareholders. Further, the RBI has also provided the necessary clarity in respect of investments by registered FVCIs in listed securities, subject to the FVCI Regulations.

Having said that, one question that could arise out of the Circular is: Would FVCIs be allowed to invest in all instruments permissible under the FVCI Regulations? It is too early to interpret this Circular to anything beyond what is obviously stated here, but if one could potentially look at this Circular as a move toward harmonizing the FVCI regime entirely with the FVCI Regulations and effectively giving SEBI single point regulatory responsibility for this regime, which was how this regime originally was envisaged to operate, it could bring the FVCI regime on par with venture capital fund regulations in terms of choice of investment instruments.

While FVCIs have been granted specific permission by the RBI to purchase eligible securities by way of private arrangement or purchase from a third party, based on recent interactions with the RBI, there seems to remain a restriction on the ability of a FVCI entity to sell the shares of an Indian venture capital undertaking to non-resident non-FVCI investors. This may significantly impact the exit opportunities available to FVCIs.

Conclusion

In the gloom set out by the Government's recent Finance Budget, this move by the RBI seems to come as a fresh breath for foreign private equity investors. Further, in an environment that presents interesting opportunities in listed entities, combined with more flexible takeover regulations now, with a higher limit for open offer trigger, the clarification on FVCI investment in listed securities is likely to be received with some excitement.

Needless to say, a big relief for FVCIs would come if the RBI decided to follow the footsteps of the Finance Minister and remove the sectoral limitations that have been imposed on FVCIs since 2008. The recent proposal in the Finance Budget is to extend the tax "pass-through" status to venture capital funds for their income from investments in Indian venture capital undertakings operating *in all sectors* by removing the sectoral limitations under current Section 10(23FB) of the Income Tax Act, 1961. Likewise, a move to remove such sectoral restrictions imposed on FVCIs by the RBI, which have significantly eroded the benefits of the FVCI regime, would bring much needed parity between venture capital funds and FVCIs, sending out a strong positive message to the offshore investing community.

The text of the Circular is available on the RBI's website at http://rbidocs.rbi.org.in/rdocs/notification/PDFs/AP93I190312.pdf.

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