Funds Hotline

July 02, 2013

ANGEL FUNDS: A NEW PRODUCT OFFERING ON THE ALTERNATIVE INVESTMENT FUNDS PLATFORM

Securities and Exchange Board of India (SEBI) has recently approved amendments to the SEBI (Alternative Investment Fund) Regulations, 2012 ("**AIF Regulations**") providing a framework for setting up funds focused on investments in start-ups ("**Angel Funds**"). The proposal aims to provide Indian entrepreneurs an expanded access to capital.

Historically, angel funding was conducted in the private domain on a one to one basis. The amendments provide these investments the mainstream AIF platform and accordingly acknowledge that the Indian startup ecosystem is maturing as an asset class. In this hotline, we analyze SEBI's proposed amendments.

SEBI'S PROPOSAL

The AIF Regulations regulate all forms of vehicles set up in India for pooling of funds from investors, Indian or foreign, on a private placement basis. The AIF Regulations have defined several categories of funds with the intent to distinguish the investment criteria and relevant regulatory concessions that may be allowed to them.

Category I AIFs encompasses AIFs with a defined investment strategy focusing on Venture Capital Funds, Small and Medium Enterprises Funds, Social Venture Funds and Infrastructure Funds, which in SEBI's view, lead to "... positive spillover effects on the economy".

SEBI has now approved an amendment ("**Proposed Amendments**") to the AIF Regulations to allow for 'angel funds' to be added as a sub-category to "Venture Capital Funds", a form of Category I AIFs.

SALIENT FEATURES OF THE PROPOSED PLATFORM FOR ANGEL FUNDS

Following are some of the key aspects of the Proposed Amendments as discussed in SEBI's press release of June 25, 2013:

Investor ticket size and corpus of the fund: The minimum ticket size for investors has been kept at Rs. 2.5 million (approx. USD 41,667) as against Rs. 10 million (approx. USD 166,667) for other AIF categories. This is a welcome move as it allows the investor opportunity to diversify risk of investment concentration.

The Proposed Amendments also require that the committed capital be drawn down within 3 years. This leaves ambiguity as to the validity of drawdowns post commitment period and could pose problems in cases where the investment manager of the fund is not able to fully drawdown / call capital within the period.

Investor qualification: Individual angel investors are required to have an experience of at least 10 years for early stage investments / as serial entrepreneur / as a senior management professional and also have net tangible assets of at least Rs. 20 million (approx. USD 333,333).

The requirement of prior experience may have been to ensure participation by investors who understand the risk/ return profile of this asset class. However, this limits the universe of eligible investors who may be approached to raise commitments for such funds. Further, while investors with entrepreneurial background bring better governance and professional management experience, this may be more applicable in case of their direct investment into start-ups where they participate as shareholders. In case of Angel Funds, it would be the fund manager who would be managing the fund and expected to provide such value to the start-up. In our view, SEBI should consider limiting the investor qualification only to their net worth - as a measure of their risk carrying appetite in line with global standards.

Corporate angel investors are required to have a minimum net worth of Rs. 100 million (approx. USD 1,666,667) or are alternatively required to be a registered AIF or a venture capital fund.

Continuing Interest: The Proposed Amendments prescribe the level of sponsor commitment (lower of 2.5% of fund's corpus or Rs. 5 million (approx. USD 83,333)) as 'continuing interest'. This expression is used in all categories of AIFs currently and has caused concerns as to whether by 'continuing interest', the sponsor commitment would have to be locked till the end of the life of the fund. Such an interpretation would not be in consonance with the typical 'distribution waterfall' and more critically, would imply that sponsor's interest cannot be aligned with that of the investors in the Angel Fund. The industry has been requesting this clarification from SEBI.

A clarification or non-use of 'continuing interest' in the Proposed Amendments would have been helped alleviate any concerns in this regard.

Investee companies: Conditions have been imposed that to be eligible to receive 'angel funding', the investee company has to be within 3 years of its incorporation, not listed on the floor of a stock exchange, have a turnover of less than Rs. 250 million (approx. USD 4,166,667) and not be promoted by or related to an industrial group (with group turnover exceeding Rs. 3 billion (approx. USD 50,000,000).

Research Papers

Compendium of Research Papers
April 11, 2024

Third-Party Funding for Dispute Resolution in India
April 02, 2024

Opportunities in GIFT City
March 18, 2024

Research Articles

Private Client Insights - Sustainable Success: How Family Constitutions can Shape Corporate Governance, Business Succession and Familial Legacy
January 25, 2024

Private Equity and M&A in India: What to Expect in 2024?
January 23, 2024

Emerging Legal Issues with use of Generative AI
October 27, 2023

Audio

IBC allows automatic release of ED attachments: Bombay HC reaffirms
April 15, 2024

The Midnight Clause
February 29, 2024

Enforceability of unstamped or inadequately stamped Arbitration Agreements
January 10, 2024

NDA Connect

Connect with us at events, conferences and seminars.

NDA Hotline

Click here to view Hotline archives.

Video

Cyber Incident Response Management
February 28, 2024

Webinar : Navigating Advertising

Deal ticket size / holding period of investments: The Proposed Amendments require that the deal ticket size be between Rs. 5 million (approx. USD 83,333) and Rs. 50 million (approx. USD 833,333).

Separately, the Proposed Amendments require that an investment be held for a period of at least 3 years. If the intention is to ensure that only patient capital enters the angel ecosystem, the same can be achieved by restricting investment redemption for the specified period. Secondary transactions should be allowed so that liquidity for the investor is achieved. Clarity in this regard would be helpful.

Inclusion within the fold of Venture Capital Funds: Post the Finance Act, 2012, income is made taxable directly in the hands of investors (of venture capital funds registered under the SEBI (Venture Capital Funds) Regulations, 1996) on an accrual basis and the pooling vehicle is not to be subject to any tax. The AIF Regulations and the Finance Act, 2013 limit the benefit of this 'pass - through' only to Venture Capital Fund sub-category of Category I AIF. Addition of Angel Funds within the fold of Venture Capital Funds (under the AIF Regulations) seems to suggest that SEBI seems to have taken a view that tax 'pass- through' be permitted to Angel Funds as well.

Globally, investment funds rely on a 'tax pass-through status' wherein the income of the investment fund is taxed directly in the hands of its investors, but not at the level of the fund itself. This provides fiscal neutrality to the funds as it eliminates tax at the pool level while maintaining taxation at the investor level. A pragmatic view would have been that the tax pass-through status should have been extended, in line with standard international practice, to all pooling vehicles/funds including to Category II AIFs, Category III AIFs and other Category I AIFs such as infrastructure funds, Small and Medium Enterprise funds etc. which may not necessarily fall within the definition of a VCF or a VCC as defined under the AIF Regulations. It must be noted that the tax pass-through status does not per se result in non-payment of taxes, but merely ensures that taxation of income is in the hands of its ultimate beneficiary.

A tax advantage does come about by being classified as a 'Venture Capital Fund' as per Section 56 of the Income Tax Act, 1961. Clause (viib) of sub-section (2) of Section 56 deals with the taxability of the sum received by a company, on account of issue of shares at a premium. The clause however does not apply where the consideration for issue of shares is received by a Venture Capital Undertaking from a Venture Capital Company or Venture Capital Fund (which now technically shall also include Angel Funds).

CONCLUSION: WAY FORWARD

SEBI should be commended for recognizing angel funds as a distinct asset class. Further, the parameters for investor eligibility seem to have been introduced in due regard the risk weightage that SEBI attaches to angel investments. However, any regulatory framework which impedes exits (thereby affecting liquidity), could impede the growth of this asset class.

- Adhitya Srinivasan, Prasad Subramanyan and Richie Sancheti
You can direct your queries or comments to the authors

DISCLAIMER

The contents of this hotline should not be construed as legal opinion. View detailed disclaimer.

Laws in India Part II Fireside Chat with Manisha Kapoor
February 27, 2024

Webinar : Navigating Advertising Laws in India
February 20, 2024