Foreign VC funds may wish to register with SEBI

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The Indian media are flooded daily with explosive figures earned by venture capital investors. Increasingly, new domestic and offshore funds are being formed with a specific India and industry focus. One avenue open to investors is to set up a foreign venture capital (VC) fund in India.

The Securities and Exchange Board of India (SEBI) regulates domestic VC funds. In 2000 SEBI introduced the Foreign Venture Capital Investor (FVCI) regulations that govern offshore funds and specify investment criteria for private equity and offshore VC investors. Foreign VC funds can invest directly in India under the prevailing FDI policy or under the FVCI regulations.

For the latter, a foreign VC fund must register with SEBI. To encourage registrations, SEBI has provided certain benefits. FVCIs can invest in registered domestic venture capital funds or in a venture capital undertaking. This is a domestic, unlisted SEBI-registered fund whose activities do not fall within the government's restricted list.

Eligibility criteria

A VC fund can operate in India after obtaining a certificate of registration. A FVCI may register with SEBI as long as it fulfils eligibility criteria that allows SEBI to evaluate the applicant's experience/competence, financial soundness, track record, and determine whether a foreign regulatory authority regulates the offshore fund. Further, the FVCI must disclose its investment strategy and the life cycle of the fund at the time of registration and must achieve the investment conditions by the end of its cycle. The onus is on the applicant to satisfy SEBI. Other key conditions include:

- At least 66.67% of the funds must be in unlisted equity shares or equity linked instruments.

- Not more than 33.33% of the investible funds may be invested by way of (a) subscription to an IPO of a VCU whose shares are proposed to be listed; (b) debt or a debt instrument of a VCU in which the VC fund has already made an investment, by way of equity; (c) preferential allotment of equity shares of a listed company subject to the lock-in period of one year, (d) equity shares or equity-linked instruments of a financially weak company or a sick industrial company whose shares are listed.

A special purpose vehicle must be created to facilitate investment according to prescribed regulations.

Pros of registering

It is not mandatory for FVCIs to register with SEBI but both SEBI and Reserve Bank of India have extended certain benefits.

Foreigners must seek approval from the Foreign Investment Promotion Board (FIPB) to make investments in the same field of activity as their existing investments in India but FVCIs registered with SEBI are exempt.

The income of SEBI-registered venture capital funds established to raise funds for investment in venture capital undertakings is exempt from income-tax as long as it complies with SEBI and other regulations. This exemption confers a "pass-through" status, which means income earned by way of dividend, interest or capital gains, upon distribution, would continue to retain the same character in the hands of its investors. Registration with SEBI benefits the fund and its investors. However, the Finance Act, 2007 limits this tax exemption to income earned from unlisted Indian companies in certain industries. This change will impact domestic funds while foreign funds may be able to choose where they are taxed. Thus, FVCIs may continue to enjoy tax benefits.

Under the guidelines for capital issues, the entire pre-IPO share capital of a company is locked for one year from the date of allotment. This lock-in does not apply to shares held by SEBI-registered VC funds, giving the FVCI freedom to exit from its investments.

The entry pricing norms for foreign direct investment is regulated for foreign investors and purchase of shares is linked to the net asset value of the shares of an unlisted company. Exits, too, are monitored and disinvestment is linked to net asset values, while share prices of a listed company are capped at the price on the stock exchange. FVCIs are exempt from the norms.

The public offer provisions of the SEBI Takeover Code necessitate that a public offer be made to the other shareholders of the company to buy up to 20% of the paid-up capital of the company from them. These do not apply when a FVCI transfers shares to the promoters.

FVCIs registered with SEBI have a special status under the listing guidelines and are eligible to participate in and subscribe to shares in an IPO through the typical book-building route as qualified institutional buyers.

Some cons

The registration process can take up to eight weeks. Additionally, a FVCI must maintain financial records and SEBI can inspect those at any time for eight years. Also, a FVCI needs to pay special heed the structure of investment and, based on the home country, can avail of benefits accorded under double-tax avoidance treaties.

Priti Suri is the proprietor of PSA.