India Regulatory Update

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The Indian economy has been famously dubbed the elephant economy. Lately, the fabled elephant has unfortunately been bogged down by shackles. Criticism from the investor community suggests that India's legal and regulatory systems have not kept pace with business and the requirements of an increasingly globalized economy. In response, the Government has recently taken significant steps to seek to remedy this situation. Noteworthy amongst these steps is a long overdue overhaul of the existing company law regime, proposed rationalization of investment routes into India, recognition of certain previously prohibited exit rights in investment agreements and formulation of regulations to govern angel funds. These recent developments should help in building investor confidence and are discussed in greater detail below.

The Companies Act, 2013 – A perspective for investors

The Companies Act, 2013 ("2013 Act") received the President's assent on August 29, 2013 and is now in the statute book. The 2013 Act intends to replace a five decades-old law and has ushered in a new era in corporate law and governance. Currently only 99 out of 470 sections have been made operative. It is expected that the remaining provisions will be made operative in a staggered manner.

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Provisions under the old company law that correspond to the 99 operative sections under the 2013 Act have ceased to have effect. However, all other provisions under the old law continue to remain in force during the transitional period.

Guiding principles

This legislation will have far reaching consequences for corporates undertaking business in India, now and in the future. The dominant themes that cut across many of the provisions of the 2013 Act are increased transparency, better corporate governance, a strong protection of shareholder interest, external party accountability (such as auditors, practicing company secretaries) and mandatory corporate social responsibility. To tie in all these ends, the 2013 Act prescribes the creation of a National Company Law Tribunal, a specialist body that will enforce and regulate the provisions of the 2013 Act.

An important concept that emerged under the 2013 Act is progress from shareholder supremacy towards stakeholder supremacy, where the stakeholders in relation to a company are much broader than shareholders. The 2013 Act codifies that the duties of a director would extend to acting in the best interests of the company, its employees, the shareholders, the community and protection of the environment. This principle is prevalent across multiple aspects under the 2013 Act.

Corporate governance

In the last decade, corporate India has been rocked by scandals and controversies relating to corporate governance. The policy-makers have tried to plug these gaps and make all stakeholders accountable. The severity of penalties prescribed for non-compliance has been increased considerably as compared to the earlier company law. The 2013 Act has introduced the concept of fraud in relation to the affairs of a company. It makes fraud punishable with pecuniary fines of up to three times the amount involved and up to a maximum of ten years imprisonment. Incidents of non-compliance under a number of sections of the 2013 Act have penalties linked to that of fraud. An "officer in default" could now potentially include investor nominee directors, if such directors are aware of a contravention mentioned in the board meetings or in board papers and do not object or participate or consent to such contravention. To safeguard against liability, investors would be well advised to cause the promoters and investee company to designate specified individuals of investee companies as officers in default or compliance officers.

A typical form of exit investors often rely on is a public offering of securities. The 2013 Act increases the liability of directors in relation to the prospectus for a public offering and this would translate to heightened liability for investor nominee directors. Directors can no longer avoid liability by relying on statements of experts or by claiming that there were reasonable grounds to believe that statements in the prospectus were true. The members and depositors of a company have been empowered to initiate class action proceedings if they believe that the management or affairs of the company are being conducted in a manner prejudicial to their interests.

The emphasis on corporate governance is significant. The 2013 Act contains detailed provisions on the roles and responsibilities of independent directors and auditors. Checks and balances have been imposed in relation to independent directors and auditors with a view to act as a check on the impairment of their independence. Restrictions have been imposed on loans, guarantees and security to directors and persons in whom directors are interested. Furthermore, a higher degree of scrutiny and more stringent approvals have been prescribed for related party transactions, as compared to the old law.

Mergers and acquisitions

There has been an attempt to make the M&A landscape more straightforward. In terms of cross-border transactions, Indian companies have now been allowed to merge with foreign companies located in specified jurisdictions (to be notified). This was previously not permissible. This route could be used to migrate ownership to an international holding structure, increase access to foreign markets and provide exits to investors. Further, in cases where a listed company merges into an unlisted company, the transferee company can remain unlisted, provided that the members of the transferor company are provided with an exit option with cash or other benefits in accordance with a pre-determined price formula (in the manner as may be prescribed).

Structuring considerations for investors

The 2013 Act limits the ability of a company to make investments through more than two layers of investment companies in India, subject to certain exceptions. Investors often prefer to take an exposure at the holding company level, so as to derive value from the entire target group. Investors will need to factor in this restriction when structuring investments. Another factor that investors will need to bear in mind when structuring investments is that the 2013 Act equates private companies with public companies in many aspects. This was not the case under the old law. One such example is in relation to differential rights as to dividends or voting. Under the old law, public companies were required to comply with additional rules regarding shares with differential rights while there was no such restriction on private companies. The new law treats private companies at par with public companies in this regard.

Free transferability of shares

There has been considerable debate and conflicting jurisprudence from various courts in India as to whether any restrictions can be imposed on the transferability of shares in a public company. The 2013 Act lays this issue at rest by explicitly upholding the validity of such contracts. It would now be possible to contractually agree on terms such as a right of first refusal, a right of first offer, tag along rights and call and put options in the case of a public company. This is a welcome change for the investor community.

Corporate social responsibility

The 2013 Act provides for mandatory corporate social responsibility. It provides that all companies having a net-worth of INR 5,000 million or more, turnover of INR 10,000 million or more, or a net profit of INR 50 million or more in a financial year are required to spend at least 2% of the average net profits in the last three years towards permitted social causes.

Way forward

Over 300 sections of the 2013 Act are subject to the issuance of further rules. This will entail a lot of moving parts to the legislation. Moreover, rulemaking is delegated to the bureaucracy and does not have the discipline of parliamentary debate. Six sets of draft rules have already been issued for public comments and it will need to be seen how this eventually pans out. Rules in relation to the National Company Law Tribunal and the National Company Law Appellate Tribunal have been finalized and await notification.

In conclusion, while the 2013 Act attempts to keep the corporate law current and up to speed with changing times, it will only be fair to pass a final verdict after the complete regulatory framework has been put in place. Transitioning from the old company law to this new legislation will require India, Inc. to streamline its practices and processes and it remains to be seen how soon corporates will be able to ready themselves.

Rationalization of investment routes into India

Along with the attempt at streamlining corporate law, the Government has also sought to simplify investment routes into India. There are broadly three routes for foreign investment in India of which the two major routes are foreign direct investment and foreign portfolio investment. Foreign direct investment has the connotation of establishing a lasting interest in an enterprise for the long term, while foreign portfolio investment is primarily targeted towards investing in listed shares through exchange trades and is generally considered short term capital. On January 7, 2014, the Securities and Exchange Board of India ("SEBI"), the capital markets regulator, has issued the SEBI (Foreign Portfolio Investors) Regulations, 2014 ("FPI Regulations"). The FPI Regulations introduce a new regime for foreign investors investing in India under the foreign portfolio investment route.

Pursuant to the FPI Regulations, a new class of investor known as foreign portfolio investors ("FPIs") has been put in place. This new class of investors merges the two earlier categories of foreign investors making portfolio investment, i.e. foreign institutional investors and qualified foreign investors.

The key eligibility criteria prescribed for applicants seeking registration as an FPI includes: (i) the applicant is not resident in India and is resident in a country whose securities market regulator is a signatory to the International Organization of Securities Commission's multilateral memorandum of understanding or who has signed a bilateral memorandum of understanding with SEBI, (ii) in case the applicant is a bank, such entity is resident of a country whose central bank is a member of the Bank for International Settlements, (iii) the applicant is not resident in a country identified in the public statements of the Financial Action Task Force as a jurisdiction having deficiencies, including in relation to anti-money laundering or the financing of terrorism, (iv) the applicant is permitted to invest in securities outside the country of its incorporation and its charter documents permit the applicant to invest on its own behalf as well as on behalf of its clients, and (v) the applicant has sufficient experience, good track record, is professionally competent, financially sound and has a generally good reputation of fairness and integrity.

The FPI Regulations provide that existing SEBI registered foreign institutional investors and qualified foreign investors will not be required to register as FPIs until the expiry of their residual term for which they have paid registration fees to SEBI. Upon the expiry of the residual period, such entities will be required to pay the prescribed conversion fees and obtain registration as FPIs in order to continue to make foreign portfolio investments in India. That said, all foreign institutional investors and qualified foreign investors are required to comply with the provisions of the FPI Regulations with effect from January 7, 2014.

The FPI Regulations provide simpler entry, monitoring and reporting norms and provide for a cost effective framework for FPIs to operate within. Every applicant is required to register itself under one of the following three FPI categories:

(i) Category I FPI - foreign governments and foreign government related investors;

(ii) Category II FPI - regulated broad based funds, appropriately regulated entities, broad-based funds whose investment manager is appropriately regulated, university funds, university related endowments, pension funds etc.; and,

(iii) Category III FPI - a residual category of investors that does not fit within (i) and (ii) above, such as endowments, charitable societies, foundations, corporate bodies, trusts, individuals and family offices.

SEBI has proposed a risk based "know your client" (KYC) approach for FPIs as per their categories. FPIs are required to register with designated depository participants on behalf of SEBI and not directly with SEBI, as was the case earlier with foreign institutional investors. Simplification of the registration process is a positive step and will make it easier for foreign portfolio investors to invest in India.

These regulations come at an opportune time as a lot of concerns have been raised regarding the flight of foreign funds away from the Indian capital markets.

Put/call options and preemptive rights for investors

In another significant development, the SEBI issued a notification on October 3, 2013, permitting pre-emptive rights such as tag-along/drag-along rights, rights of first refusal, rights of first offer and call and put options in investment agreements of public limited companies. This marks a major shift in SEBI's stance. SEBI in the past had steadfastly stuck to its position that such provisions were in contravention of the law. Until recently, the enforceability of such provisions with respect to public companies was not free from doubt. The SEBI notification has some riders attached. It has been stipulated that the selling party of a put option must hold the title and ownership of the underlying securities for a minimum of one year from the date of entering the contract, the consideration paid on the exercise of any option must be in compliance with the relevant guidelines for pricing as are stipulated by SEBI and the Reserve Bank of India ("RBI"), India's central bank, and the contract must also compulsorily be settled by way of actual delivery.

> "The Foreign Portfolio Investors Regulations provide simpler entry, monitoring, and reporting norms, as well as a cost effective framework for FPIs"

The RBI has issued a circular dated January 9, 2014, pursuant to which it has permitted optionalities (which intend to cover put options) in relation to equity shares, compulsorily convertible preference shares and compulsorily convertible debentures issued by Indian companies to persons resident outside India, subject to meeting with the minimum lock-in and pricing prescribed by the RBI. The guiding principle that the RBI has set forth is that foreign investors should not be guaranteed any assured exit price. The RBI was against put options because it believed that by virtue of such rights, foreign investors were able to achieve guaranteed returns on equity and therefore their investments were essentially debt masquerading as equity. Debt raised from foreign entities is required to comply with additional requirements as per RBI regulations.

In terms of pricing, the RBI has prescribed that the exit price in case of a put option on the equity shares of a listed company will be the market price as determined on the floor of the exchange. In case of an unlisted company, the exit price pursuant to a put option of equity shares should be less than the Return on Equity ("RoE") as per the latest audited balance sheet. RoE has been defined to mean profit after tax divided by the net worth and net worth is to include free reserves and paid up capital. However, in case of compulsorily convertible preference shares and compulsorily convertible debentures, the pricing for an exit by way of a put option can be arrived at as per any internationally accepted pricing methods as certified by a chartered accountant or SEBI registered merchant banker.

The RBI has put to end a long standing controversy regarding the use of put options by foreign investors. In case of equity shares of listed companies, the RBI has sought to link the exit pricing to the market price on the stock exchange, which is an expected benchmark. However, this benchmark could perhaps be prone to abuse as compared to the earlier pricing benchmark of the higher of 26 weeks or 2 week average of the weekly high and low closing prices quoted on the stock exchange. In the case of a put option of compulsorily convertible preference shares and compulsorily convertible debentures it seems that there is a fair amount of latitude provided to parties to determine the exit pricing. However, the exit pricing prescribed in relation to unlisted equity shares seems to be restrictive.

The minimum price at which a foreign investment can currently be made in unlisted equity shares is determined on the basis of the discounted cash flow valuation of the equity shares. The discounted cash flow valuation takes into account the future performance of the company based on specified variables. An RoE valuation takes into account the historical returns made on the equity investment. Accordingly, when an investment has been made on the basis of the discounted cash flow value, determining the exit pricing pursuant to a put option on the basis of the historical return on equity may be restrictive in certain cases and may not convey the actual fair value of the equity shares.

The RBI has further stipulated that all existing contracts will need to comply with the above mentioned lock in and exit pricing conditions to qualify as compliant with exchange control laws. Accordingly, it will need to be assessed whether existing contracts need to be amended or not.

Recognition of put options by the SEBI and RBI is a welcome move for foreign investors and has provided much needed clarity after many years. That said, the pricing stipulations imposed by the RBI in the case of a put option of unlisted equity shares may prove to be restrictive.

Angel Funds

In May 2012, SEBI had first issued regulations for governing alternative investment funds ("AIF Regulations"). On September 16, 2013, SEBI amended the AIF Regulations to provide for the recognition of angel funds as a distinct investment class within the alternative investment funds regime. While some argue that the regulations for angel funds are needlessly prescriptive, the fact that SEBI has recognized angel funds as a separate class is itself a welcome move.

The amended AIF Regulations provide that investors who propose to invest in an angel fund should have early stage investment experience or experience as a serial entrepreneur or be senior management professional with at least 10 years experience. Individual investors who propose to invest in an angel fund will be required to have net tangible assets of at least INR 20 million. Corporate entities that propose to invest in an angel fund will be required to have a net worth of INR 100 million or be an alternative investment fund/ venture capital fund registered with SEBI. Angel funds should have a minimum corpus of INR 100 million and the minimum investment by an investor in any angel fund should be INR 2.5 million. The sponsor/ investment manager of an angel fund should maintain a continuing interest of not less than 2.5% of the corpus of the angel fund or INR 5 million, whichever is lower.

To ensure that investments made by angel funds are genuine angel stage investments, angel funds will only be permitted to invest between INR 5 million and INR 50 million in investee companies, and such amounts will be locked in for a period of three years. Further, investments will only be permitted in investee companies that are: (i) incorporated in India and are not more than three years old, (ii) do not have a turnover exceeding INR 250 million, (iii) are unlisted, (iv) are unrelated to an industrial group whose group turnover is in excess of INR 3,000 million, and (v) there is no family connection between the investee company and the investors proposing to invest in such investee company.

India generally lacks the depth in seed-stage and early-stage funding. Various studies have highlighted that there are numerous seed-stage companies in India that require funding. Most of these companies approach venture capital funds. Institutional venture capital funds typically have a high ticket size and therefore these seed-stage companies sometimes have no choice but to raise funds from the unorganized market at a high cost. The framework provided by SEBI in relation to angel funds should help in boosting fundraising to cater to seed-stage and early-stage companies in India.

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The India story going forward

As per World Bank estimates, India is the 10th largest economy in terms of nominal GDP. India's GDP has grown at a compounded annual growth rate of 7.9% between 2003 and 2013. This marks a phase of strong growth despite the global financial crisis during 2008–2009. Growth has however recently slowed due to a variety of domestic as well as global factors. Structural reforms will be the key fundamental drivers to sustain the India story. One such structural reform is making the regulatory environment conducive to business, and the efforts outlines here are a step in the right direction.

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