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INDIA PRIVATE EQUITY & VENTURE CAPITAL LANDSCAPE 2017

CONTENTS

Sectors which witnessed activity during the year were primarily real estate, BFSI, IT & ITES. Interestingly, over 24 percent of the total investment value in these sectors is committed by a single Japanese investment fund. These numbers do in fact paint a promising picture for 2018. It is also seen that, investors have largely preferred late stage funding as opposed to early stage angel or seed funding.

Rajesh N. Begur

Founder & Managing Partner
ARA LAW

An investment in knowledge pays the best interest.

- Benjamin Franklin

2017, was an eventful year for the country – and we witnessed a strong Q2 and Q3 on the heels of a slow Q1, followed by India's 30-point jump in Ease of Doing Business Index and most recently, an upgrade in sovereign ratings by Moody's Investors Service (a global bond credit rating agency) rankings for the first time in almost 14 years. A major part of these positive dynamics can be attributed to the **structural and fundamental policy reforms** initiated this year, as well as to the hangover of some reforms initiated in 2016 – like implementation of GST; introduction of a uniform bankruptcy code; demonetization; establishment of a real-estate regulator; abolishment of FIPB; recapitalization of banks and relaxation of FDI norms. Some of these reforms normally entail short-term pain for long-term gain. But thanks to a strong backdrop of a stable political environment, coupled with a handful of marquee billion-dollar deals in IT and ITES sector, along with certain other investments, the year saw the PE & VC deal value numbers grow by over USD 3 billion (mostly consummated) compared to the same period of the previous year – even as deal volumes have not shown a similar trend!

Exits in 2017 YTD registered a record high of USD 9.4 billion, with many PE & VC investments of the last 2006 -2007 vintage having made profitable exits. It is equally critical for existing PE & VC investors to make handsome returns to further enthuse the market.

Sectors which witnessed activity during the year were primarily real estate, BFSI, and IT & ITES. Interestingly, over 24 percent of the total investment value in these sectors is committed by a single Japanese investment fund. These numbers do in fact paint a promising picture for 2018. It is also seen that, investors have largely preferred late stage funding as opposed to early stage angel or seed funding.

Venture debt has also shown promise, and a pool of focused venture debt funds may pave way for a gradual shift from equity to debt and debt along with equity being the most preferred route for bridge-funding. Debt has shown tremendous fervor from foreign investors, including FPIs, and FPI investments have been on a record high with almost the entirety of the combined corporate debt limit of USD 51 billion for FPI investments being subscribed to in August - September this year. In fact, based on an independent survey of investors conducted by us, it was opined that debt along with equity may be the most preferred way of capital funding for 2018, as it provides a greater flexibility to the investor as well the investee.

Trends from our own survey as well as certain third-party reports data for 2017 have been provided in Part II the handbook to give readers a holistic view of the landscape.

A Wish-List for the coming year to flag our suggestions and recommendations is also included to showcase our expectations from the policymakers for the coming year in this sector. As predicted in the last edition, we saw a tremendous jump in the position of the country in Ease of Doing Business Rankings in 2017 – which is hopefully going to strengthen investor faith in parking more funds in the country – supplemented by IMF's promise that India continues to be (one of the) fastest growing economies in the world despite the economy slowdown. Another prediction made in our last edition has also come partially true in the form of a tax exemption to start-ups for 7 years. The Moody's rankings upgrade is further going to lend more credibility to the country and possibly lower borrowing costs for the government and companies, while increasing the dollar-bond supply from India. In our view, the real ratings would be the ensuing state elections in Gujrat and Himachal Pradesh.

This handbook is a representation of our motto, ethics and a continuous endeavor to give our clients optimum and quality solutions for the tasks they entrust us with. For your reference, we have added a select 12 of our articles dealing with relevant updates and evolving issues along with our views and observations – in specific, around the PE & VC space and generally, around the legal and regulatory landscape of the country. We are also pleased to share some pictures of "The PE & VC Conclave", a PE & VC - focussed conference, hosted by ARA Law at the The Taj West End in Bengaluru in 2016, to give our readers a quick glance of the event (We missed those of you who could not attend)! On a concluding note, we wish for a strong Q4 and expect the numbers to get even bigger, and the trends even better, for 2018 as well. As of now, we will only say that with the world showing faith in India, now may be the best time to visit the vibrant PE & VC landscape of the country. With this thought we are happy to present the 2nd edition of our handbook for the year 2017.

I extend my heartfelt gratitude to our clients and business partners for contributing to this handbook and for enabling us to present our best!

We don't have to be smarter than the rest. We have to be more disciplined than the rest.

- Warren Buffet

Warm Regards

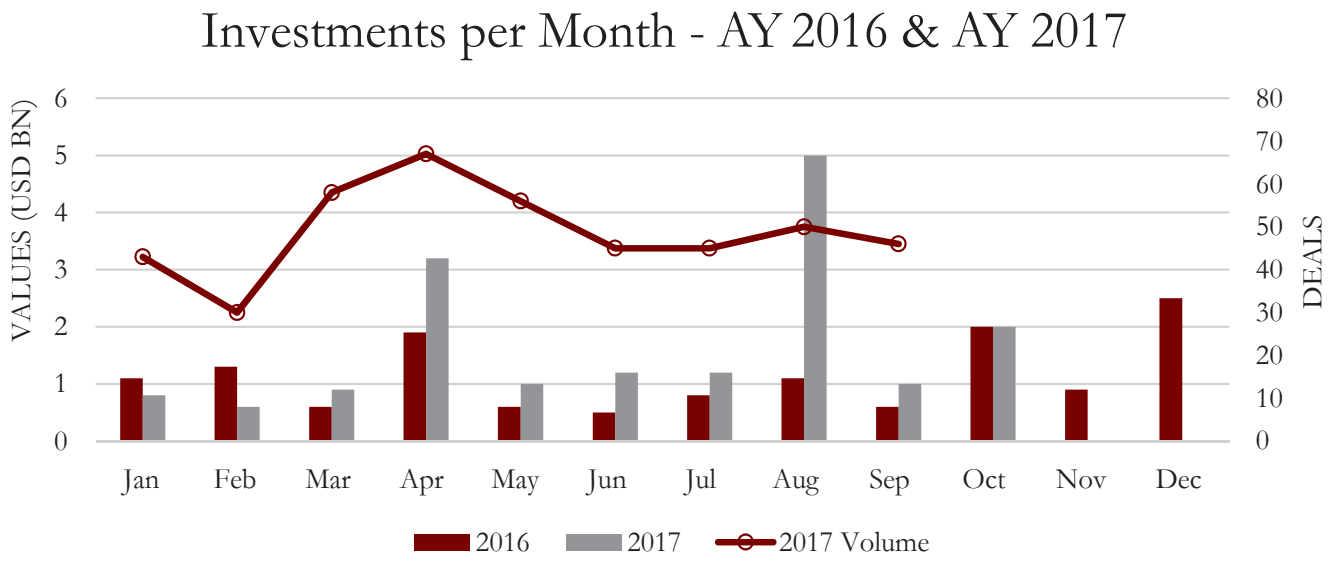
Rajesh N. Begur

PE &VC 2017: THE YEAR IN FOCUS

INVESTMENT TRENDS : SECTORAL ANALYSIS AND MARKET BEHAVIOUR

2017 – YEAR IN FOCUS AND EXPECTATIONS FROM 2018

PE & VC investments, after a decline in the initial months of AY 2017, started picking up by the end of Q1 and reached a position escalated by almost 40 % as of Q3, as compared to the same period of AY 2016. Q3 surprised the market with a tremendous jump in deal volume as well as value. As shown in the graph, the long-term India growth story remains intact – owed in no small part to a stable curency coupled with continuing government reforms (notwithstanding the impact of demonetization announced in November last year).



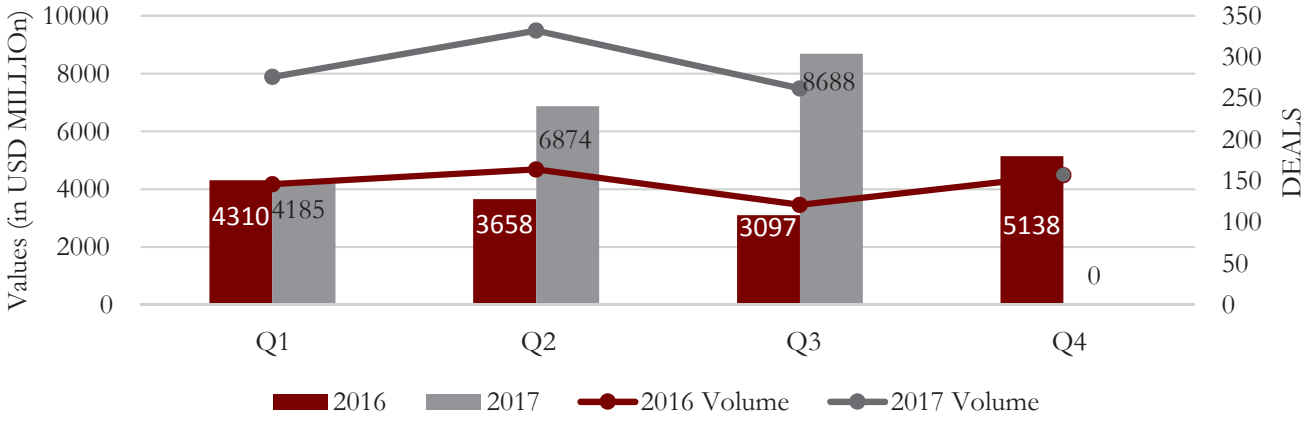
Source: Grant Thornton

On a quarterly basis, Q2 & Q3 saw a remarkable increase of investments by around 180% and 17% in volume, as compared to the same period in AY 2016. The first eight months of AY 2017, from January to October, saw a 51 % jump compared to the whole of last year. At the current pace, the Q4 is expected to close with a high bench mark like Q3. Overall, around USD 5.7 billion was invested across 46 deals in Q3 – interestingly the highest quarterly growth investment ever, owed to two billion-dollar deals in the quarter.

Q3 also recorded 19 deals of values greater than USD 100 million, aggregating to around USD 7 billion and accounting for 80% of investments for the quarter. Buyouts and PIPE deals recorded strong growth of 132% and 201% respectively in the quarter. Early stage/VC funding continued to dominate volumes. AY 2017 has overall witnessed a greater number of large-size deals compared to the previous years, thereby confirming the faith of investors and the maturity of the Indian PE market.

The graph below compares the deal values and volumes of AY 2016 & AY 2017 and as can be seen, while Q1 was similar to the past year, Q2 & Q3 have been much better – with Q3 performance being quite spectacular indeed!

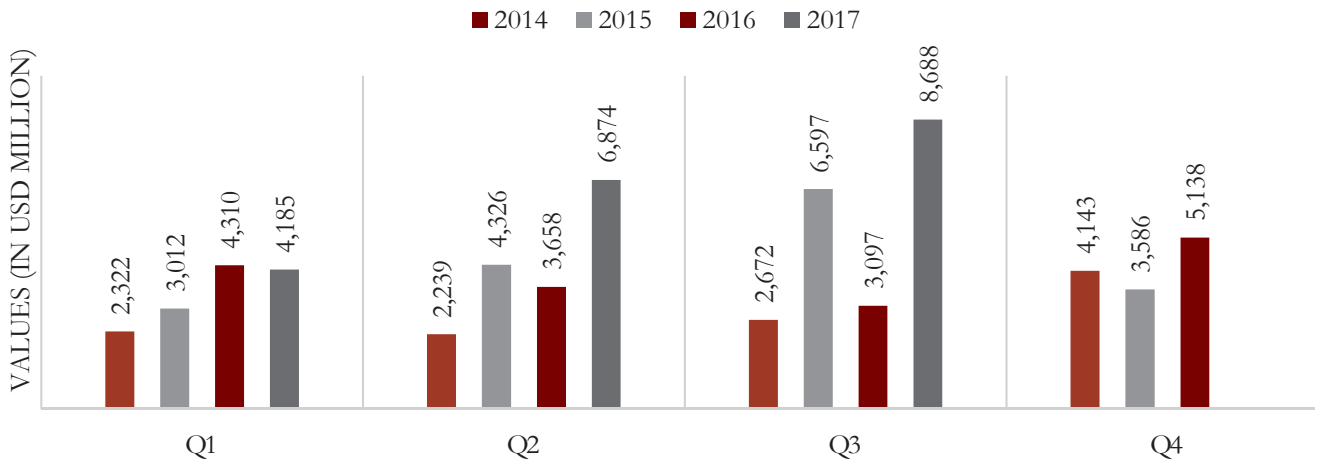
Investments by Quarter (Only PE) - AY 2016 & AY 2017



Source: Grant Thornton

The graph below further compares quarter-wise investment values over the years since AY 2014. As can be seen, the values have consistently improved over the years, despite a slow-down in AY 2016 values which only show that the trend has overall been positive.

Investments (Includes PE & VC) by Quarter AY 2016 & AY 2017

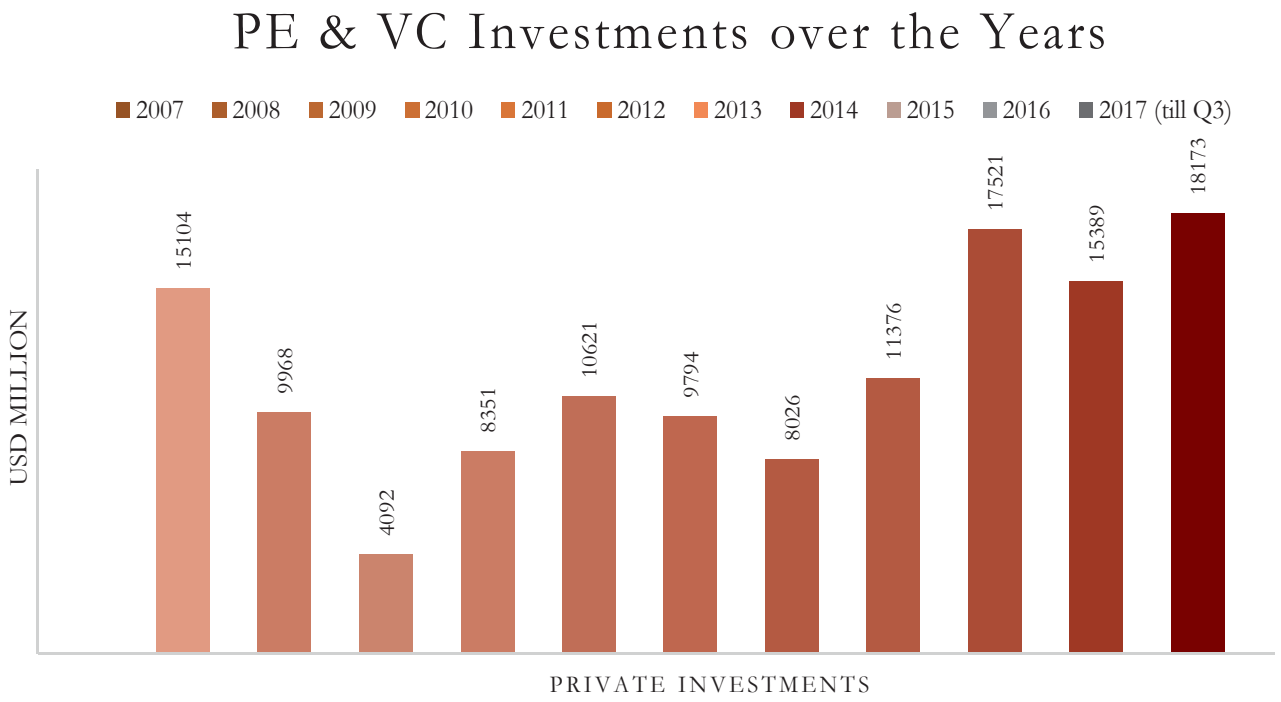


Source: Venture Intelligence

Although numbers for Q4 are not yet available, our independent reports suggest that it is in all likelihood going to showcase a performance similar to Q3. We cannot be more elated!

The overall scenario of PE & VC investments in AY 2017 has been good till now with the total volume being already higher than the final figure of AY 2016. However, it will be interesting to see whether with a positive looking Q4, AY 2017 will be able to surpass AY 2015 as well? The positive numbers for the year owe much to a healthy Q3 which hit a record USD 5.4 billion across 45 deals. According to an EY Report, this

has been the highest monthly value of investments ever! According to the same report, there was a 5.4 time jump in PE & VC investments in August as compared to USD 1 billion in August 2016, mainly driven by two mega deals – Softbank's USD 2.5 billion investments in Flipkart and GIC's USD 1.4 billion investments in DLF commercial property assets.



Source: Venture Intelligence

A robust increase in deal value in the period between AY 2015 & AY 2017, as seen above, is primarily due to an increase in big ticket size deals and improved exit environment. A large number of players also believe that the increase in interest shown by offshore investors has contributed fairly well to the figures of AY 2017.

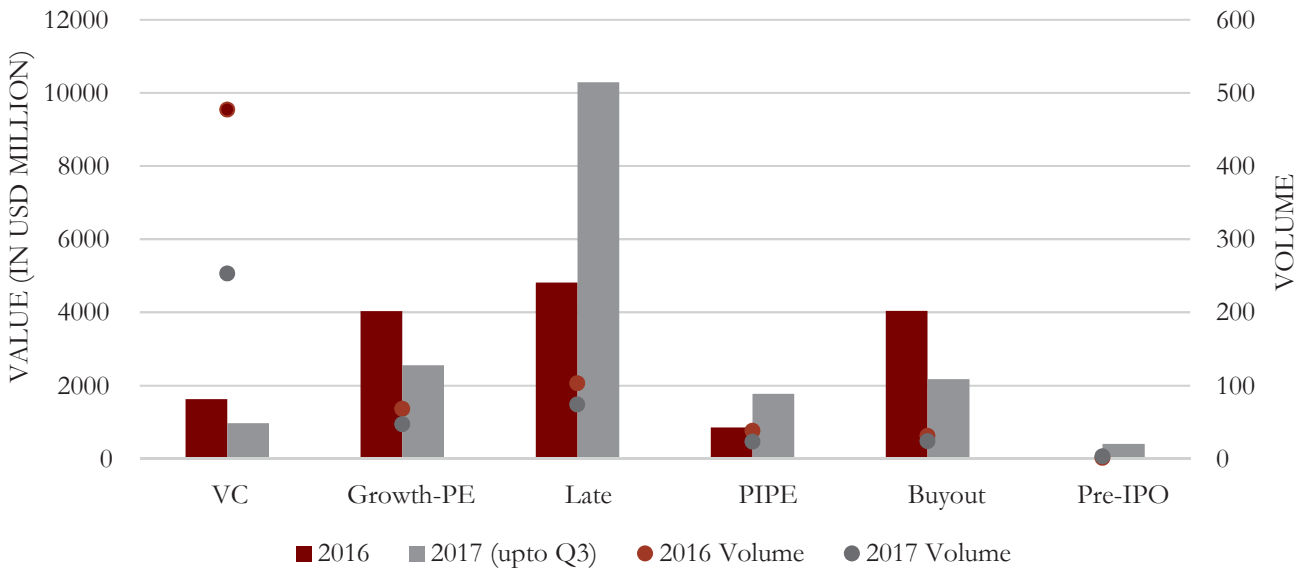
Another important aspect is the difficulty in raising Series B rounds. This can be owed to several reasons, including the failure to live up to the initial projections made during first funding rounds. Interestingly, a considerable number also believe that the same is due to lower tolerance level amongst the investors in the given market conditions.

Further, for the year AY 2018, both investments (fresh and follow on) and exits should be targeted to balance the expected deal volume size and to get a high rising trend in the coming years. A majority of the investors concur to the fact that in the given market dynamics, 'buy outs' will be the most preferred investment strategy during AY 2018, followed by follow on investments (i.e. Series B and so on).

For AY 2017, we have provided below, an analysis of the investments by stage, as compared to AY 2016. As can be seen, late stage investments continued to dominate the numbers by values while early stage/

VC investments continued to show strong numbers in volumes. A slight drop in both values and volumes can be seen at the growth-stage as compared to last year, which can be attributed to the focus of investors on the already PE-backed ventures. This may represent a shift in the investor sentiment – of moving towards businesses that have surpassed the growth stage and continued to show performance as opposed to riskier - yet - promising growth stage businesses.

Investments by Stage for AY 2016 and AY 2017 (Upto Q3)

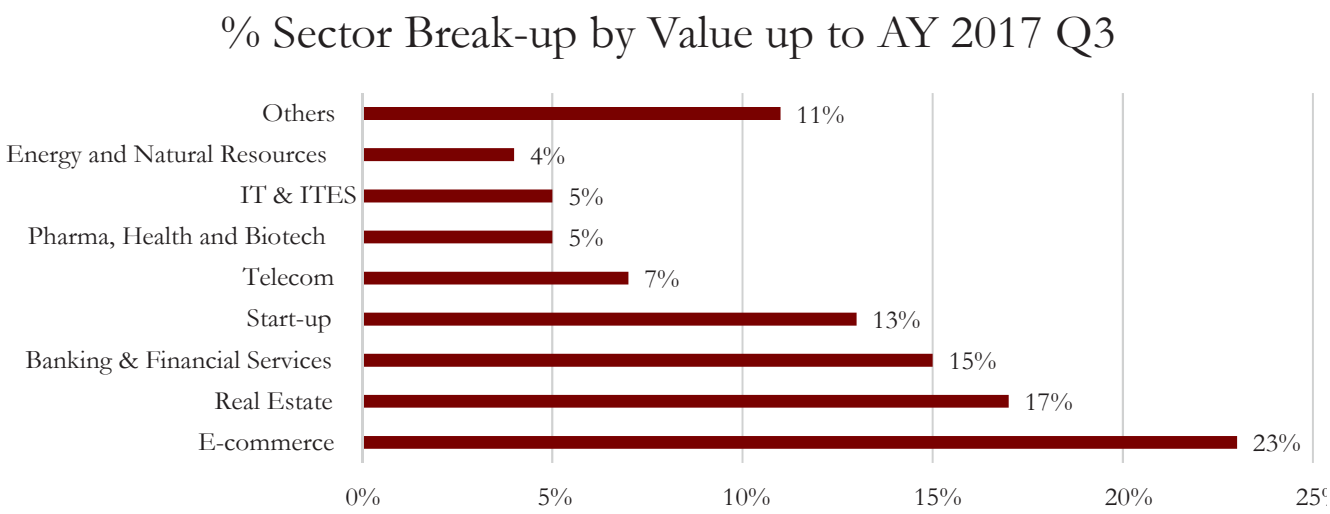


Source: Venture Intelligence

Overall, the year has been quite positive with more value being infused YTD as compared to values infused in AY 2015 and AY 2016, despite 23 % lesser deals as compared to the last year, as can be seen from the graph above. The same is primarily due to a slowdown in small-ticket deals. However, Series A and B and seed funding for Q3 has been on a decline, despite usually being the most common investment stages generally. This reflects a change in the investor mindset, with most investors now looking for stronger, and performance based companies than early-stage start-ups. The next part of the chapter focuses on more detailed sector-wise investment trends for the year.

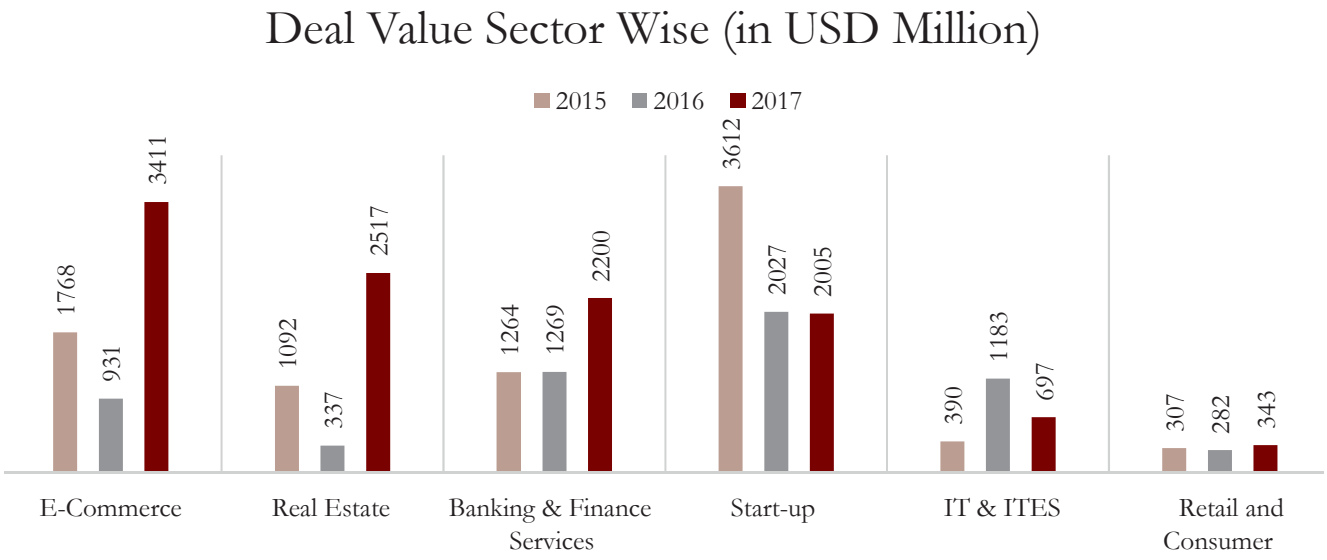
SECTOR FOCUS

In terms of the most lucrative sector in AY 2017, e-Commerce, in spite of a sharp fall in investments by the end of AY 2016, emerged as the most attractive sector followed by real estate. Except Healthcare and Pharmaceutical, every sector witnessed a positive (though somewhat below expectation) spike in value. Over all, the highest amount of funding continues to be attracted by consumer technology start-ups which, inter alia include fin-tech, travel-tech and health-tech. Majority of investors consider Healthcare and Pharmaceutical, followed by IT & ITES to be the leading sectors in the coming year.



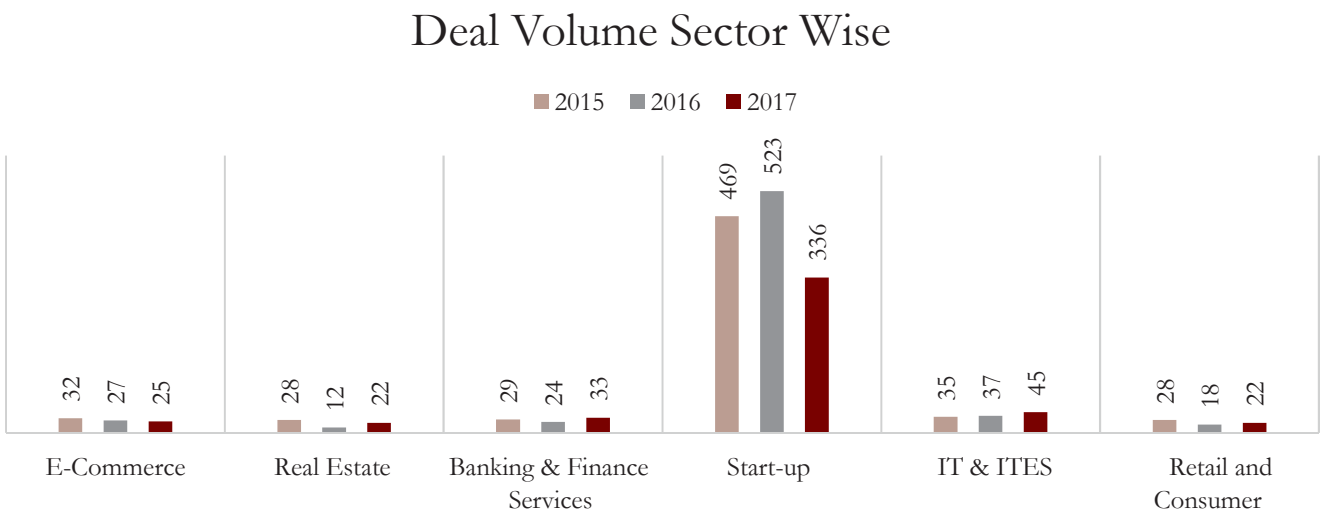
Source: Grant Thornton

In terms of numbers, E-Commerce recorded around USD 2.6 billion in terms of Q3 investments across 18 deals, while Real Estate recorded around USD 2.3 billion across 13 deals. Similarly, BFSI recorded USD 1.4 billion infusion across 25 deals in the quarter. Technology, on the other hand, recorded a decline of 44 % in values in the quarter compared to the same period last year, despite being at par in terms of deal volume. Comparing the numbers with AY 2016 & AY 2015, a consistent decline in Start-up sector investments can be seen, compared to Real Estate and e-Commerce. IT & ITES have continued to maintain a stable position despite a fall in value from last year while Retail and Consumer remains consistent over the period.



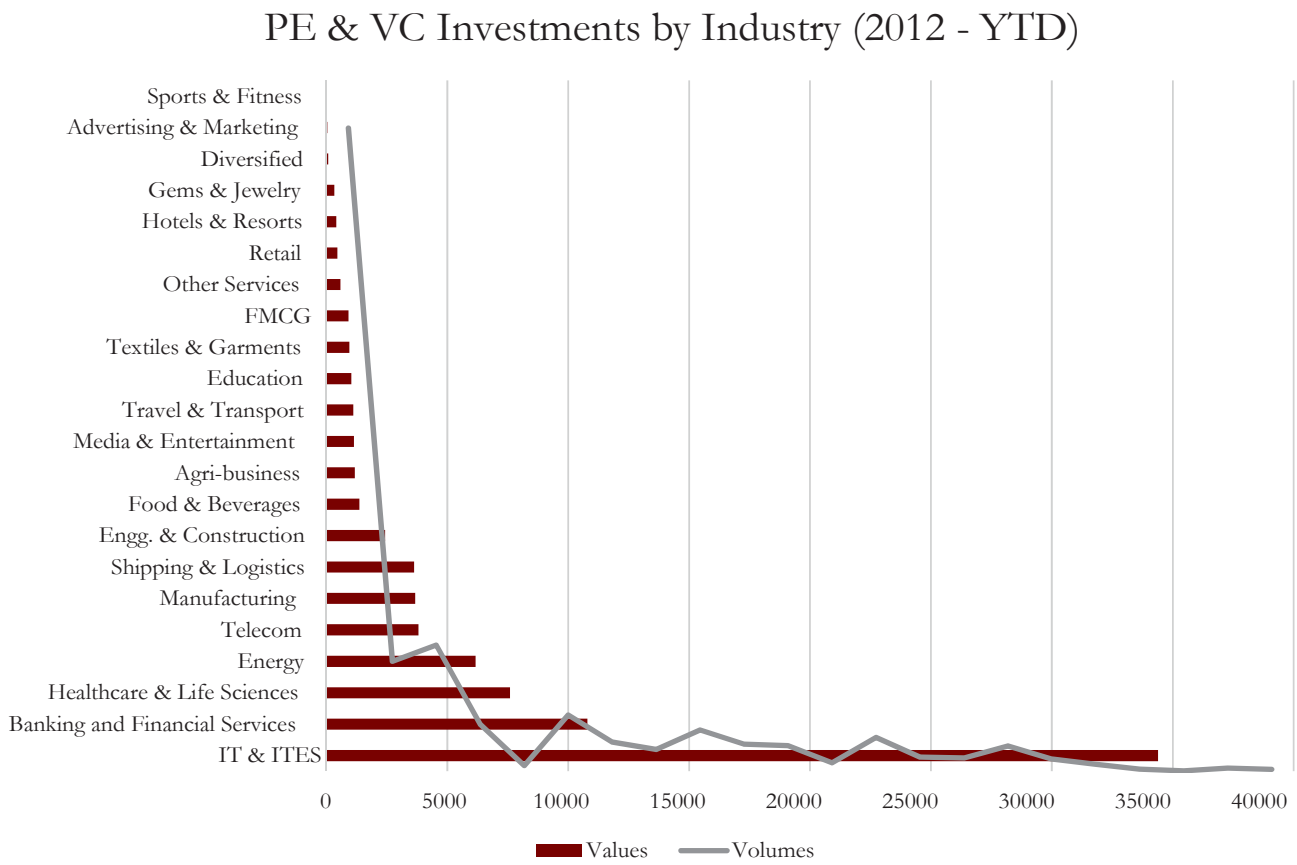
Source: Grant Thornton

Overall, we expect a boost in numbers for the Start-Up sector for Q4 and AY 2018 following the impact of policy initiatives which started last year. Deal volumes for sectors below show a decrease in the start-up sector while the others have shown a stable increase. In addition to big-ticket investments gaining prominence, the above goes on to show that the market is overall maturing and focus is also being diverted towards dormant sectors as well.



Source: Grant Thornton

For the readers' ease of reference, we have included below a graph which reflects the investments across sectors since AY 2012. This graph not only provides a much better idea of investment distribution across the sectors but also provides information on the investment values and volumes in sectors across the last half decade.

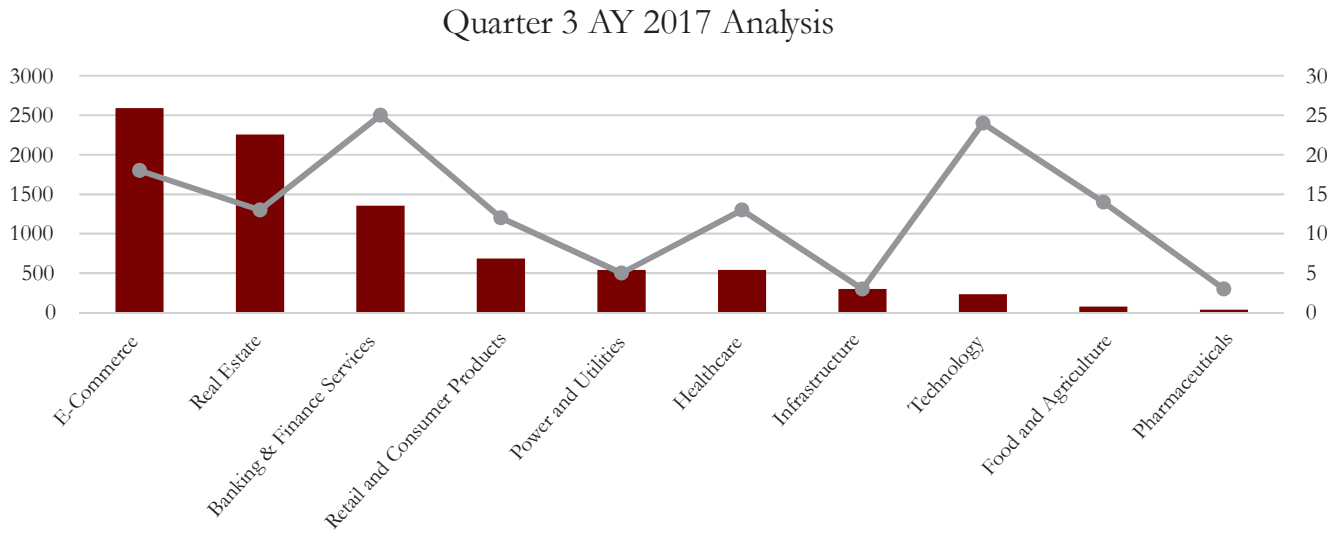


Source: Venture Intelligence

As can be seen, IT & ITES, followed by BFSI has received the most amount of funding through PE & VC channels and the trend continues more or less the same way per year. However, as mentioned above, this year we have seen a lot of dormant sectors getting active. Therefore for AY 2018 we would like to see more activity in unconventional sectors like Sports and Fitness, Advertising and Marketing, FMCG, etc. As

of date, on the basis of data available to us, the three sectors have seen only 5, 9 and 38 deals respectively compared to the stronger sectors like Healthcare with 365 deals or IT and ITES with almost 2000 deals.

On the whole, private equity firms have invested about USD 17.6 billion in Indian companies across sectors in the first nine months of AY 2017, sailing past the previous high of USD 17.3 billion in AY 2015. Compared to last year, the investments have risen by 48 % year-on-year in value backed by said big ticket investments.



Source: Ernst and Young

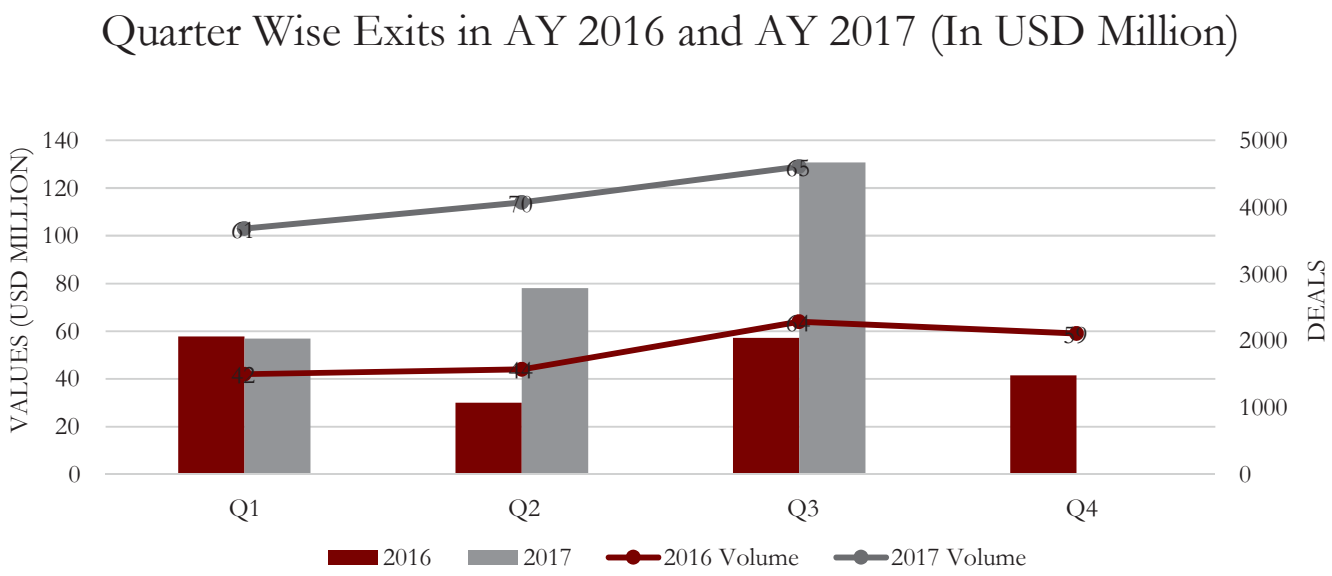
EXITS – 2017

As compared to the previous year, PE &VC exits began on a slow note in AY 2017. Q1 of the year saw a total deal value of USD 0.2 billion off 61 deals. But the total deal value and number of deals both picked up pace in Q2 (with a value of almost USD 0.3 billion) off around 65 deals. However, by the second half of the year, a huge jump in deal value and volume as compared to Q1, Q2 and the previous year was visible wherein August 2017 recorded 25 exits totalling USD 1.9 billion, almost 4 times, as compared to exits in August AY 2016 which has been the highest value of exits in a month, ever. In terms of volume, at 25 exits, August AY 2017 recorded an increase of 19 % compared to August AY 2016.

Across sectors for the end of Q3, BFSI recorded the highest value and volume of exits, followed by Power and Utilities, Real Estate and then E-Commerce. The most favored exit route continues to be secondary market sales, followed by open market sales. However, exits via IPOs recorded the highest value for the said route in any quarter, thanks to the largest IPO exit ever by a PE fund in India (Fairfax-ICICI Lombard). As far as numbers are concerned, the total value of exits via IPOs in AY 2017 is greater than the overall value recorded in the last 8 years – reflecting that the IPO markets have been quite active. YTD 12 PE backed IPOs have taken place and almost another 12 are awaiting listing by the end of the year, compared to 17 such IPOs in AY 2016.

Open market exits also recorded 32 deals of over USD 1.5 billion in the third quarter, more than double for the same period in AY 2016. While exits via secondary sale recorded almost the same

number through 9 deals. Both reflect the highest quarterly value of exits through the said routes since AY 2009.



Source: Ernst and Young

For Q3, September recorded over a 5 times increase in value of exits compared to the same period last year (USD 2 billion across 24 exits vs USD 388 million across 22 exits in September AY 2016). However, on a month-on-month basis, exits declined 5 % in value terms and 27 % in volume term.

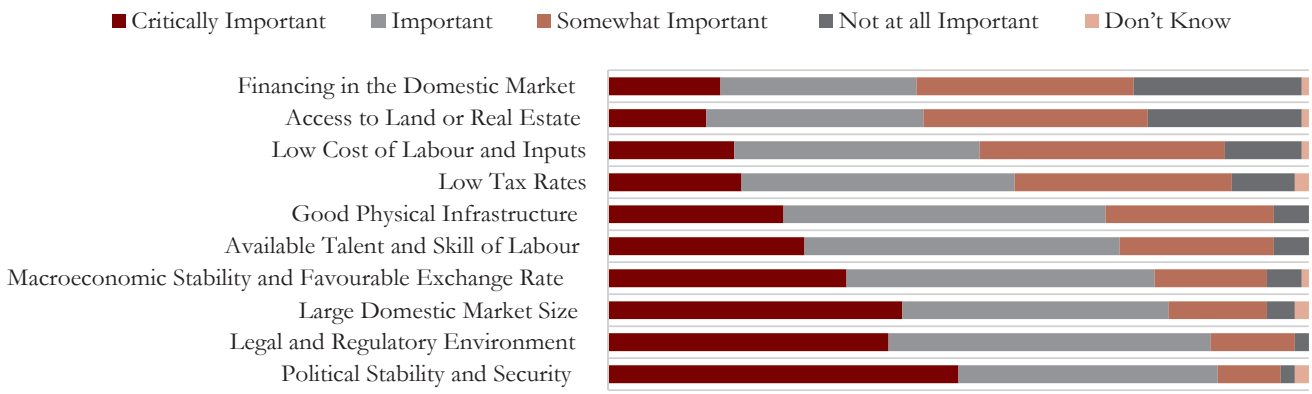
Years AY 2015 to AY 2017 were expected to be the exit years for most of the funds which raised capital in the bullish market a decade ago. Do you believe vintage investments made during the 2006-07 have seen positive exits or do you believe that considerable exits have not been achieved yet?

INVESTOR SPEAK

A survey of investors across the globe, conducted by the World Bank, to record investors' views and expectations while investing in a developing country is sproduced below for the reader's reference. According to said survey, an easier regulatory regime is not all that matters to investors while investing. As can be seen, around 50 % of investors give importance to political stability and security as compared to a smaller demographic (40 %) which finds legal and regulatory environment to be the most important. Our own independent survey is in consonance with the below results and shows a polarized opinion amongst investors of the dynamically changing regulatory environment in India. For instance, while a significant number of investors from our survey believed that the government has done 'enough' to improve ease of doing business in India, a huge number also felt that there is a long way still to go.

While India continues to plan a 40-notch jump in the coming couple of years, we must keep in mind the areas where its rank has not only been questionable over the years but also dropped over the last year despite the spectacular performance. According to the World Bank report, while incentives may be a more important part of the value proposition to efficiency-seeking investors, they may not be as attractive for a FDI entry, as the same tends to concentrate geographically in relatively few locations despite the broad availability of incentives.

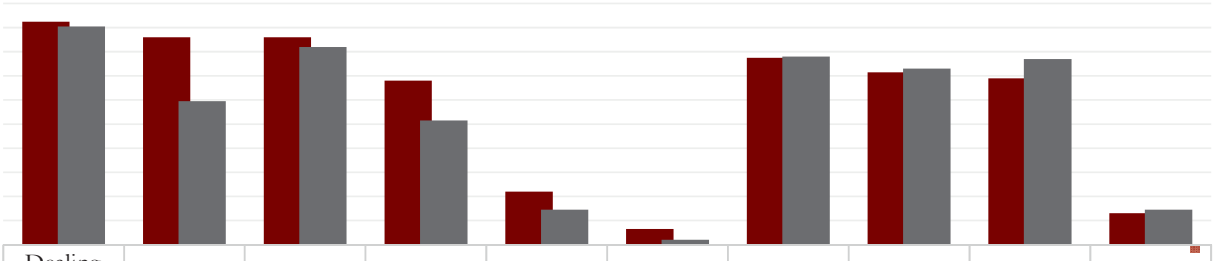
Factors Affecting Investment Decisions



Source: World Bank Report titled Foreign Investor Perspectives and Policy Implications

We have provided below a few of the parameters the World Bank looks at for ranking countries on the Ease of Doing Business Index. Though India has displayed good rankings consistently with respect to Protecting Minority Investors benchmark, its rank has dropped in at least 3 other benchmarks over the last year (see below). Significant areas of concern are the time it takes to start a business, getting electricity connections and dealing with construction permits (where it ranks 181 out of 190).

India Rankings across World Bank Parametres for AY 2017 and AY 2018



	Dealing with Construction Permits	Paying Taxes	Enforcing Contracts	Resolving Insolvency	Getting Credit	Protecting Minority Investors	Starting a Business	Trading across Borders	Registering Property	Getting Electricity Connection
2017	185	172	172	136	44	13	155	143	138	26
2018	181	119	164	103	29	4	156	146	154	29

Source: World Bank Report titled Foreign Investor Perspectives and Policy Implications

OUR REPRESENTATIVE DEALS FOR 2017

The year 2017, in spite of being not very high in volumes, saw some very interesting deals taking place in the PE & VC sector. The market witnessed an interesting trend of gradual shift of focus from 'equity' to 'debt' funding. ARA Law, an expert in both the sectors closed a series of complex and value-enhancing deals in the otherwise dull and slow environment. Some of the publishable deals that ARA Law represented on in the past year include:

INVESTOR(s):
Volition Capital

TARGET:
Securonix Consultancy LLP

DESCRIPTION:

The deal involved investment by the Investor, a US based growth equity firm, in relation to its series A round of investment in the Target, a security intelligence services provider having its offices in the US and India - along with various other co-investors

ROUND: Series A

INVESTOR(s):
Malabar India Fund Limited; Mauritius Limited

TARGET:
Neuland Health Science Private Limited; Neuland Pharma Research Private Limited; Evolvence India Life Sciences Fund; ABG Capital; LTR Focus Fund.

DESCRIPTION:

The deal involved investment by the Investors along with four other investors in the equity shares of the Target, on a secondary sale basis. MIFL also purchased the compulsorily convertible preference shares of Target.

INVESTOR(s):
IIFL Seed Ventures Fund I, RPG Ventures and other investors

TARGET:
Hit the Mark Inc. (Hopscotch)

DESCRIPTION:

The deal involved investment by the Investors in the Target, a Delaware corporation, by subscribing to preferred convertible stock in the Series C round along with Eduardo Saverin (the existing investor).

ROUND: Series B

INVESTOR(s):
Jungle Ventures

TARGET:
Paysense Pte Limited and its Indian Subsidiary

DESCRIPTION:

The deal involved investment by Jungle Ventures II Investment Holding Pte. Ltd in the Target company incorporated in Singapore with a subsidiary in India engaged in the business of developing software and activities for payment, lending and credit solutions to customers through online/android based platform.

ROUND: Series A 1

BORROWER(s)
Jindal Worldwide Limited

LENDER:
IREP Credit Capital Private Limited

DESCRIPTION:

The deal involved advising the Lenders for a term loan facility to the Borrower for the purpose of meeting working capital requirements and assisted with drafting of the Facility Agreement and other definitive security agreements.

BORROWER(s):
Rinac India Limited;

Modular Cold Rooms Private Limited.

LENDER:
Piramal Finance Limited

DESCRIPTION:

The deal involved advising the Borrowers and the Promoters in relation to availing the term loan facility from one of the prominent lenders for meeting the funding requirement of Modular for purchasing the entire stake of a Mauritius based investment fund in Rinac.

BORROWER(s):
Mark Remedies Private Limited and Amanta Healthcare Limited

LENDER:
Kohlberg Kravis Roberts

DESCRIPTION:

The deal involved advising the Borrowers in relation to availing the term loan facility from the Lender for meeting the funding requirement and purchasing the entire stake of existing investors, coupled with debt investment by the Lender in the Borrowing entities which are proposed to be merged in future.

INVESTOR(s):
ICICI Prudential Asset Management Company Limited

TARGET:
Casa Grande Grace Private Limited

DESCRIPTION:

The deal involved investment by the Investor in the Target (a Real Estate Developer) by subscribing to Non–Convertible Debentures in the real estate entity. The Developer intended to invest the same in large realty project in Tamil Nadu.

INVESTOR(s):
Volition Capital

TARGET:
Securonix Consultancy LLP

DESCRIPTION:

The deal involved investment by the Investor, a US based growth equity firm, in relation to its series A round of investment in the Target, a security intelligence services provider having its offices in the US and India - along with various other co-investors.

ROUND: Series A

INVESTOR(s):
Small Industries and Development Corporation of India

FUND:
Stakeboat Capital Fund -I

DESCRIPTION:

The deal involved advising the Targe,t a Category II Alternate Investment Fund in relation to the investment made by the Investors. Accordingly, we updated the Private Placement Memorandum, Contribution Agreement and other ancillary documents.

INVESTOR(s):
Kalaari Capital Partners, III, LLC; MUGH 1 LTD

TARGET:
Bestdealfinance.com

DESCRIPTION:

The deal involved Series B-1 investment in the Target by the two Mauritius based Investors Kalaari Capital Partners, III, LLC and MUGH 1 LTD, Kalaari and a set of angel investors being existing investors in the Target by virtue of their Series A investment.

ROUND: Series B1

KEY DEVELOPMENTS IN THE REGULATORY LANDSCAPE

2017 saw many legal developments brought about by SEBI, RBI and DIPP with respect to the PE & VC sector. Below are the month-wise relevant updates starting January 2017 to YTD -

JANUARY

CBDT issues final guidelines for determination of POEM

The Central Board of Direct Taxes (CBDT) issued the final guidelines for determination of the Place of Effective Management (POEM) of a company. The final guidelines take forward the concept laid down in the draft guidelines for POEM determination based on the bifurcation of companies engaged in active business outside India and other companies. It *inter alia* provides clarification on the following areas: computational aspects for the determination of 'active business outside India' test; exclusion for shareholder decisions by the parent company; broader strategic and policy decisions to be relevant in determining POEM, as against routine operational decisions for oversight of day-to-day business operations; non-applicability to companies having turnover or gross receipts of INR 500 million or less in a financial year.

Source – CBDT Circular No. 6 of 2017 dated January 24th, 2017

Protection of interests of investors in securities

In case a custodian is unable to deliver the securities that are received subsequent to write off due to any unforeseen circumstances namely deemed Foreign Portfolio Investor/Foreign Portfolio Investor no longer existing/operating or expiry of SEBI registration/FEMA approval, etc., the sale of these securities through stock exchange and proceeds thereof net of expenses shall be credited to the Investors Protection and Education Fund of SEBI not later than 7 days from the date of receipt thereof.

Corporate benefits received in the form dividend shall be now credited to the Investors Protection and Education Fund of SEBI not later than 7 days from the date of receipt of the same.

Source – IMD/HO/FPIC/CIR/P/2017/001

Actions taken by SEBI for the non-compliance in relation to issuance of securities

SEBI has taken action against 256 (as on January 10th, 2017) entities for issuance of securities in the form of non-convertible and convertible preference shares/ non-convertible and convertible debentures/ equity shares to public, without complying with the prescribed provisions of law.

Companies were cautioned not to issue securities to public without complying with provisions of law. Investors were also cautioned not to subscribe to such issues and advised to see whether any such entity has filed offer document or filed application with Stock Exchange for listing.

Individuals/Entities acting as Debenture Trustees without being registered with SEBI, were advised not to act in the said capacity.

Source – PR No.: 8/2017 dated January 30th, 2017

FEBRUARY

Investments by FPIs in corporate debt securities

FPIs can now invest in the following: a) unlisted corporate debt securities in the form of non-convertible debentures/bonds issued by public or private Indian companies b) Securitized debt instruments : Any certificate or instrument issued by a special purpose vehicle (SPV) set up for securitization of asset/s where banks, FIs or NBFCs are originators; and/or any certificate or instrument issued and listed in terms of the SEBI (Public Offer and Listing of Securitized Debt Instruments) Regulations 2008.

Investment by FPIs in securitized debt instruments shall not be subject to the minimum 3-year residual maturity requirement.

Source – SEBI/HO/IMD/FPIC/CIR/P/2017/16

Issuance of Rupee denominated bonds overseas – Multilateral and Regional Financial Institutions as Investors

In order to provide more choices of investors to Indian entities issuing Rupee denominated bonds abroad, it has been decided to also permit Multilateral and Regional Financial Institutions where India is a member country, to invest in these Rupee denominated bonds.

Source – RBI/2016-17/233A. P. (DIR Series) Circular No.31

MARCH

RBI issues circular on Investment by Foreign Portfolio Investors in Government Securities

The RBI issued circular for investment by FPIs in government securities subsequent to its previous Sept 2016 circular. The limits for investment by FPIs in Central Government Securities and State Development Loans (SDLs) for the quarter April-June 2017 were proposed to be increased by INR 110 billion and INR 60 billion respectively. The revised aggregate limit for the April-June, 2017 was raised to INR 2580 Billion from INR 2410 billion, with revised limits being effective from April 1st, 2017. All other conditions, including the security-wise limits, investment of coupons being permitted outside the limits and investments being restricted to securities with a minimum residual maturity of three years, would continue to apply.

RBI issues circular on Operational Guidelines for Indian subsidiaries of non-resident companies in terms of operational flexibility in risk management and interbank dealings.

RBI issued circular notifying guidelines To provide operational flexibility for booking derivative contracts to hedge the currency risk arising out of current account transactions of Indian subsidiaries of Multi-National Companies where the user is a non-resident parent of an Indian subsidiary outside India, for all FCY-INR derivatives. The circular lists down 9 (nine) operational 'guidelines, terms and conditions' for hedging. The transactions are mandated to be a tri-parte agreement between the Indian subsidiary, the AD bank and the non-resident parent, which must be incorporated in a country that is a member of the FATF. Moreover, the non-resident entity, can contract any product either under the contracted route or on past performance basis which the Indian subsidiary is eligible to use. Moreover the said entity can approach the AD Cat-I bank to hedge the currency risk of and on the bank's behalf, where the concerned AD bank would be responsible for monitoring all hedge transactions and ensuring that the Indian subsidiary has the necessary underlying exposure for the hedge transactions. The profit/loss of the hedge transactions must be settled in the bank account and books of accounts of the Indian subsidiary. The AD bank must obtain from the Indian subsidiary an annual certificate by its Statutory Auditors for the same. Furthermore, the AD banks are to report all such hedged contracts to the CCIL's trade repository with a special identification tag.

APRIL

FPI to trade in derivatives on equity shares.

SEBI registered FPIs, operating in IFSC, and eligible entities which are incorporated and operating in IFSC shall be now eligible to trade in 'derivatives on equity shares.'

Source–SEBI/HO/MRD/DRMNP/CIR/P/2017/31

Amendment to SEBI (Foreign Portfolio Investor) Regulations, 2014

An express provision shall be inserted in the regulations to prevent Resident Indians/NRIs or the entities which are beneficially owned by Resident Indians/NRIs from subscribing to Offshore Derivative Instruments.

Source – PR No.: 25/2017 dated April 26th, 2017

MAY

Regulatory requirements for issue of pre-paid Payment Instruments by Co-operative Banks

It was decided to permit co-operative banks to issue Open System PPIs.

Criteria: CRAR should not be less than 10% in the current and preceding financial year; Gross NPAs should be less than 7% and net NPAs should not be more than 3% in the current and preceding financial year; Assessed net-worth should be more than INR 25 crore as per the last RBI inspection.

Source – RBI Circular No.5/07.01.000/2016-17 dated May 25th, 2017

SEBI Introduced Online System for Portfolio Managers and Venture Capital Funds

The system provides a comprehensive solution for all the regulatory compliances

All applicants are required to submit their applications on the online system at https://siportal.sebi.gov.in

All SEBI registered Venture Capital Funds are required to file their reports and submit applications for any request online.

Source – EBI Press Releases PR No.: 29/2017 dated May 30th, 2017

Information Technology Framework for the NBFC Sector

RBI laid down the directions for the IT framework for NBFCs. Along with IT governance, IT Policy, it also provides for the directions on Cyber Security, IT Operations, etc. The directions spread over 2 parts, first part dealing with the Systematically Important NBFCs (i.e. with asset size more than 500 crores) and the second one dealing with other NBFCs (i.e. with asset size less than 500 crores).

Source – RBI Master Direction DNBS.PPD. No.04/66.15.001/2016-17 dated June 8th, 2017

Amended safe Harbor rules on transfer pricing for international transactions issued

The CBDT has now amended the safe harbor rules by extending the applicability to an additional category of international transaction as well revising the applicable price/margins that would be accepted as arm's length. The safe harbor provisions are now extended up to FY 2018-19 with certain modifications in thresholds for the eligible international transactions.

Source – CBDT Notification No. GSR 557 (E) [No. 46/2017 (F. No. 370142/6/2017 – TPL)]

CBDT Notifies Transactions Not Qualifying for Long Term Capital Exemption on Sale of Listed Equity Shares

The CBDT has notified negative categories of transactions which would not be eligible for long term capital gains exemption. However, against each such negative category, the Notification also prescribes type of transactions where long term capital gains exemption would continue to be available even when New Exemption Conditions are not met.

Source – CBDT Notification No. SO 1789 (E) [No. 43/2017 (F No. 370142/09/2017 – TPL)]

Issuance of Rupee denominated bonds overseas

The revised provisions in respect of maturity period, all-in-cost ceiling and recognized lenders (investors) of Masala Bonds as under:

a) Maturity period: Minimum original maturity period for Masala Bonds raised up to USD 50 million equivalent in INR per financial year should be 3 years and for bonds raised above USD 50 million equivalent in INR per financial year should be 5 years.

b) All-in-cost ceiling: The all-in-cost ceiling for such bonds will be 300 basis points over the prevailing yield of the Government of India securities of corresponding maturity.

c) Recognized investors: Entities permitted as investors under the provisions of paragraph 3.3.3 of the Master Direction but should not be related party within the meaning as given in Ind-AS 24.

Source – RBI/2016 17/316 A.P. (DIR Series) Circular No. 47

Acceptance of e-PAN card for KYC purpose

CBDT has introduced a facility of E-PAN (electronic PAN card) vide press release dated April 11th, 2017. Accordingly, it is clarified that E-PAN issued by CBDT can also be produced by FPI for KYC compliance. The other instructions contained in Circular dated November 17th, 2016 remains unchanged.

Source – SEBI/HO/IMD/FIIC/CIR/P/2017/068 dated June 30th, 2017

JULY

SEBI to initiate action against non -compliant companies which are exclusively listed on Dissemination Board

SEBI has decided to initiate action against the non -compliant 'Exclusively Listed Companies (ELCs) on Dissemination Board (DB)', and its directors/ promoters. These companies were earlier listed on non-operational/ derecognized stock exchanges and were required to be placed on DB. The ELCs were required to comply with the directions issued by SEBI vide circular dated October 10th, 2016

Source – SEBI Press Release PR No.: 41/2017 dated July 7th, 2017

Amendment to Investor Grievance Redressal System and Arbitration Mechanism

The SEBI has notified a Circular amending the Investor Grievance Redressal System and Arbitration Mechanism. The SEBI has issued the circular under Section 11(1) of the SEBI Act 1992, read with Section 10 of the Securities Contracts (Regulation) Act 1956 to protect the interests of investors.

Source – SEBI Circular CIR/CDMRD/DEICE/CIR/P/2017/77 dated July 11th, 2017

Customer Protection – Limiting Liability of Customers in Unauthorized Electronic Banking Transactions

With the increased thrust on financial inclusion and customer protection and considering the recent surge in customer grievances relating to unauthorized transactions resulting in debits to their accounts/ cards, the criteria for determining the customer liability in these circumstances have been reviewed. The revised directions in this regard are set out below.

Source – RBI/2017 – 18/15; DBR No. Leg. BC. 78/09.07.225/2017-18 dated July 6th, 2017

Online Registration Mechanism for Securities Market Intermediaries

The SEBI online dedicated portal for registration is operational for all intermediaries which includes Stock Brokers, Sub-brokers, Depository Participants, Mutual Funds, Merchant Bankers, Underwriters, Registrar to an Issue and Share Transfer Agents, Debenture Trustees, Bankers to an Issue, Credit Rating Agencies, Investment Advisors, Research Analysts, Portfolio Managers, Venture Capital Funds, Real Estate Investment Trusts (REITs), Infrastructure Investment Trusts (InvITs), Alternative investment Funds (AIFs), Custodians and Collective Investment Schemes (CIS).

Source: SEBI Press Releases PR No. 53/2017 dated August 16th, 2017

The FDI Policy, 2017: Major Amendments

The FDI policy 2017 allowed 100 % FDI via automatic route in many sectors, unlike the previous policies which specified a 49% cap. Some sectors, however still continue to have the 49 % cap, (e.g. terrestrial broadcasting) some can receive up to 49 % (or any other percentage specified in the circular) FDI via the automatic route, while anything beyond 49 % would require the Government approval (e.g. single brand product retail trading) FDI in NBFC has been allowed to the extent of 100 % through automatic route. However, the kinds of NBFCs are not specified.

Source – DIPP Circulars D/o IPP F. No. 5(1)/2017-FC-1 dated August 28th, 2017

Action against Exclusively Listed Companies and its Promoters/Directors pending Exit Offer to the Shareholders

In order to ensure that exit option is provided to the public shareholders of ELCs that are non-compliant with the provisions of the said circular dated October 10th, 2016 and have not submitted plan of action to the DSEs and in order to protect the interest of investors in ELCs on DB it is hereby directed that, to begin with -

a) Such ELCs and the Depositories shall not effect transfer, by way of sale, pledge, etc., of any of the equity shares and the corporate benefits such as dividend, rights, bonus shares, split, etc. shall be frozen, for all the equity shares, held by the promoters or directors of non-compliant Exclusively Listed Companies till the promoters of such non-compliant Exclusively Listed Companies provide an exit option to the public shareholders in compliance with SEBI circular dated October 10th, 2016, as certified by the concerned Designated Stock Exchanges;

b) The non-compliant Exclusively Listed Companies, its directors, its promoters and the companies which are promoted by any of them shall not be eligible to access the securities market for the purposes of raising capital till the promoters of such non-compliant Exclusively Listed Companies provide an exit option to the public shareholders in compliance with SEBI circular dated October 10th, 2016, as certified by the concerned Designated Stock Exchanges;

c) The promoters or directors of non-compliant Exclusively Listed Companies shall not be eligible to remain or become director of any listed company till the promoters of such non-compliant Exclusively Listed Companies provide an exit option to the public shareholders in compliance with SEBI circular dated October 10th, 2016, as certified by the concerned Designated Stock Exchanges.

Source – SEBI circular SEBI/HO/MRD/DSA/CIR/P/2017/92 dated August 1st, 2017

Online Filing System for Alternative Investment Funds.

a) SEBI has introduced an online system for filings related to Alternative Investment Funds (AIF). The online system can be used for application for registration, reporting and filing in terms of the provisions of AIF Regulations and circulars issued thereunder.

b) All applicants desirous of seeking registration as an AIF are now required to submit their applications online only, through SEBI Intermediary Portal at https://siportal.sebi.gov.in.

Source – SEBI circular SEBI/HO/IMD/DF1/CIR/P/2017/87 dated July 31st, 2017

Disclosures by listed entities of defaults on payment of interest/repayment of principal amount on loans from banks / financial institutions, debt securities, etc.

SEBI (Listing Obligations and Disclosure Requirements) Regulations 2015 ("SEBI LODR Regulations") currently require disclosure of material events / information by listed entities to stock exchanges. Specific disclosures are required under the SEBI LODR Regulations in certain matters such as delay / default in payment of interest / principal on debt securities, including listed Non-Convertible Debentures, listed Non-Convertible Redeemable Preference Shares, Foreign Currency Convertible Bonds (FCCBs) etc. Similar disclosures are presently not stipulated with respect to loans from banks and financial institutions. In order to address this critical gap in the availability of information to investors, listed entities shall comply with the requirements of this circular.

Source – CIR/CFD/CMD/93/2017 dated August 4th, 2017

CBDT relaxes conditions for exemption from constituting 'business connection' in India for investment funds set-up by Category I or FPIs II

a) It has been notified that the fund shall have a minimum of 25 members who are not connected persons, directly or indirectly; Any member of the Fund along with connected persons shall not have any participation interest exceeding 10 per cent, directly or indirectly; and the aggregate participation interest shall be less than 50 per cent, directly or indirectly, of 10 or less members along with their connected persons in the Fund.

b) Further, vide a separate notification, CBDT has notified list of 121 countries or territories where the investment fund should be established. The list includes jurisdictions like Mauritius, Singapore, Switzerland and Netherlands, but does not include Hong Kong.

Source – CBDT notification No. 77/2017/F. No. 142/15/2015 – TPL dated August 3rd, 2017

SEPTEMBER

Acquisition of 'control' under the SEBI (Substantial Acquisition of Shares and Takeovers) Regulations, 2011

Ascertaining acquisition of 'control' under the SEBI (Substantial Acquisition of Shares and Takeovers) Regulations 2011 requires consideration of facts and circumstances of each case. This results in a multitude of opinions. In view of the same, it was decided by the Board, in its meeting held on March 12th, 2016, to explore adoption of bright-line tests for acquisition of 'control' under the Takeover Regulations.

Source – SEBI Press Releases PR No.: 56/2017 dated September 8th, 2017

SEBI Board Meeting: Important Decisions

SEBI Board has approved certain changes in the SEBI (Infrastructure Investment Trusts) Regulations 2014 and SEBI (Real Estate Investment Trusts) Regulations 2014:

a) Allowing REITs and InvITs to raise debt capital by issuing debt securities

b) Introducing the concept of Strategic Investor for REITs on similar lines of InvITs

c) Allowing single asset REIT on similar lines of InvIT

d) Allowing REITs to lend to underlying Holdco/ SPV

e) Amending the definition of valuer for both REITs and InvITs

Further, the Board decided to have further consultation with the stakeholders on a proposal of allowing REITs to invest at least 50% of the equity share capital or interest in the underlying Holdco/ SPVs.

Source – SEBI Press Release PR No.: 57/2017 dated September 18th, 2017

OCTOBER

Non-Banking Financial Company – Peer to Peer Lending Platform

The RBI identified the category of P2P lending platforms as one of the types of NBFCs. Detailed provisions are made for the companies which:

a) Act as an intermediary providing an online marketplace or platform to the participants involved in Peer to Peer lending;

b) Do not raise deposits or lend on its own;

c) Do not facilitate or permit any secured lending linked to its platform; i.e. Only clean loans will be permitted; etc.

Source – RBI Master Directions DNBR (PD) 090/ 03.10.124/ 2017-18 dated October 4th, 2017

Submission of report of the Committee on Corporate Governance

SEBI formed a Committee on Corporate Governance in June 2017 under the Chairmanship of Mr. Uday Kotak. The terms of reference of the committee were to make recommendations to SEBI on the following issues –

a) Ensuring independence in spirit of Independent Directors and their active participation in functioning of the company;

b) Improving safeguards and disclosures pertaining to Related Party Transactions;

c) Issues in accounting and auditing practices by listed companies;

d) Issues faced by investors on voting and participation in general meetings;

Source – SEBI Press Release PR No. 60/2017 dated October 5th, 2017

Categorization and Rationalization of Mutual Fund Schemes

In order to enable an investor of mutual funds to take an informed decision while investing in a scheme, it was necessary to clearly distinguish different schemes launched by a Mutual Fund in terms of asset allocation, investment strategy etc. A need has also been felt to bring uniformity in the characteristics of similar type of schemes launched by different Mutual Funds.

In order to bring in uniformity and to standardize the scheme categories, SEBI has issued a circular laying down the categories of schemes, its characteristics and uniform description for each category.

Source – SEBI Circulars SEBI/HO/IMD/DF3/CIR/P/2017/114 dated October 6th, 2017

Master Direction on Issuance and Operation of Prepaid Payment Instruments

The RBI has issued a number of circulars from time to time on issuance and operation of PPIs. In the light of developments in the field, progress made by PPI Issuers, experience gained and with a view to foster innovation and competition, ensure safety and security, customer protection, etc., it was decided to review the instructions relating to the issuance and operation of PPIs and issue comprehensive Directions on the subject. The draft Master Direction on PPIs was placed on the RBI website on March 20th, 2017 for public feedback. The comments / views received from all stakeholders have been examined by the Reserve Bank in preparation of the final Directions. The Master Direction is effective from today. Existing PPI Issuers shall ensure compliance with the revised requirements on or before December 31st, 2017, except where timelines have been specified in this Direction.

Source – RBI master direction DPSS. CO. PD. No. 1164/02.14.006/2017-18 dated October 11th, 2017

CBDT issued clarification related to guidelines for establishing 'Place of Effective Management' in India

CBDT issued a circular clarifying that as long as the regional headquarter operates for subsidiaries/group companies in a region within the general and objective principles of global policy of the group laid down by the parent entity in the field of payroll functions, accounting, human resource functions, IT infrastructure and network platforms, supply chain functions, routine banking operational procedures, and not being specific to any entity or group of entities per se; it would not constitute a case of Board of Directors of companies standing aside and such activities of regional headquarter in India alone will not be a basis for establishment of POEM for such subsidiaries/group companies. The CBDT has also clarified that the provisions of General Anti-Avoidance Rule may get triggered in such cases where the above clarification is found to be used for abusive/aggressive tax planning.

Source – CBDT circular No. 25 of 2017 F. No. 142/11/2015 – TPL (Part-1) dated October 23rd, 2017

PE & VC - KEY ISSUES IN PERSPECTIVE

A NEW LIBERAL DIMENSION BY JUDICIARY TO 'RBI RESTRICTIONS ON EXIT AT AN ASSURED RETURN'?

RBI Restrictions on Exit at an 'Assured Return': A Glance

Till January 2014, 'Put Options' in favor of a non-resident requiring an Indian resident to purchase the shares held by the non-resident under the foreign direct investment (FDI) regime were not allowed by RBI. However, with the Circular dated January 9th, 2014, RBI formally documented that equity shares, fully and mandatorily convertible preference shares and debentures containing an optionality clause can be issued as eligible instruments to foreign investors subject to certain specified conditions including a restriction on 'an exit at assured return'.

While the aforesaid amendment was considered as a welcome development by the market players, as it gave legitimacy to the contractual provisions, which are fairly standard in the international investment context and acted as a boost up for foreign investors to invest in India. Having said that, a large chunk of market players still believes that the benefits and scope of such a development was heavily limited by imposing a prohibition on maintaining the exit option with assured returns as well as price determination based on return on equity and the same have adversely impacted investments into the equity segment.

Because of the above amendment, a lot of players chose to amend their existing shareholder's agreement or draft the new ones on line with the RBI restrictions and compliance with FDI norms on pricing and exits. However, still many others chose to continue with such provisions on assured returns and/or incorporate it in the new documents, probably with a view to take benefit of the same in case of any positive change in regulatory regime in future or liberal interpretations by judiciary in this regard.

Cruz City 1 Mauritius Holdings v. Unitech Limited: Judiciary precedents over RBI Restrictions?

In the given case, disputes arose out of an Agreement and later the award was made by the arbitral tribunal constituted under the rules of the London Court of International Arbitration (LCIA). However, the enforcement of said award was opposed by the respondent (a wholly owned subsidiary of Unitech Limited) on various grounds, one of which being contravention to the public policy of India as it violates the provisions of the Foreign Exchange Management Act 1999 (FEMA).

> In yet another investor friendly move, the Delhi High Court in *Cruz City Mauritius Holdings v. Unitech Limited*, upheld the enforcement of foreign arbitral award in India notwithstanding the issues of contravention of FEMA restrictions, inter alia, pertaining to enforceability of put option and exit at assured returns being raised as defenses against such enforcement. Although the judgement is primarily in the context of issue of setting aside or enforcement of foreign awards, but it fairly touches upon the critical issues of judicial treatment of restrictions imposed by Reserve Bank of India (RBI) on foreign investors.

Disputed Clause(s) in relation to FEMA violations under the Agreement: The clause under dispute contemplated an assured exit at a pre-determined rate to the petitioner in respect of its investment in the project and thus the same was contended as violation of the Circular issued by the RBI. It was contended that in terms of FEMA, the shares are required to be valued and purchase of those shares can only be made at the fair market value of those shares.

Judicial Treatment of the restrictions under the Circular: To the said contention of the respondent, Hon'ble Delhi High Court responded in disagreement and found the same as bereft of any merit. Surprisingly as against the customary strict interpretation of RBI restrictions and circulars, the judiciary in this case held that the restrictions under the Circular are not open ended and without any limits. Accordingly, if the Put Option has been provided for a specified limited time and contingent upon certain events than the same can't be considered as providing the guarantee of assured return at exit. Note that in the instant case, the Put Option provided to Cruz City was subject to (i) exercise within a specified time and (ii) failure to

commence the Santacruz project within the prescribed period. In the precise words of Justice Bakhru - "This was not an open ended assured exit option as is sought to be contended."

However, the court in the same judgement also made a passing reference of the possibility of such provisions being considered as violative of FEMA when it recorded an observation that "notwithstanding that Unitech may be liable to be proceeded against for violation of provisions of FEMA, the enforcement of the Award cannot be declined". Therefore, in the light of this reference the final inference on the judicial position on the permissibility of exits at assured returns and judicial treatment of RBI restrictions on the same may not be fairly assumed to be full proof!

Take-aways from the Judicial view in the given Case

- FEMA related violations are not considered as an impediment to the enforcement of a foreign arbitral award as it being contrary to the public policy of India or in violation of any RBI restrictions- at least, it gives an opportunity to contest the enforceability of the awards even when same are opposed with the charges of such strict non-compliances.
- RBI restrictions on exit at an assured return is not a blanket restriction and basis the nature of the transaction, provision on assured return may be considered as permissible by the judiciary- Although it opens the window for justifying such provisions, however, in the absence of any direct clarification from the RBI, the same may not be considered as a full proof position.
- On the one hand, the judgment is very clear on the rejection of other grounds of contention against the enforceability of foreign awards. However, in relation to the issue of FEMA contravention, their still exists an ambiguity in the intention of the court by apprehending in its conclusion to remove the possibility of a case of contravention under FEMA- Whereas the observations and interpretations of the court give a very investor friendly perspective of such restrictions under RBI provisions, but as aforesaid, the sanctity of the same is still under shades because of lack of a ratio decidendi on the said issue by the court in this or any other case.

ARA LAW View

A new judicial drift can be seen evolving where instead of out rightly rejecting the contentions on the ground of violations of RBI/FEMA norms or being against public policies, the inclination is towards flexible and investor friendly interpretations of the strict regulatory provisions. Undeniably, the trend appears to be a welcome development as it gives predictability and commercial flexibility to foreign investors and in long run will help in making India a preferred destination for the foreign investors. However, the legal sanctity of such judicial liberal interpretation is still dubious, especially in the judgments like the instant one wherein no express permissibility of such actions has been clinched.

As mentioned above, the question whether it gives an opportunity to justify the inclusions and enforceability of such provisions under the agreement could be answered as a "Fair Yes!". However, whether the same can be considered as an accepted and settled position under regulatory regime – "No!", in the absence of any clarification from RBI or amendment of the FEMA provisions to allow exits at pre-determined valuations. The principal of strict interpretation of RBI regulations, in the absence of any concluding view by the Apex Court, is advisable to be adhered to.

[*SPACE FOR NOTES*]

ENFORCEABILITY OF FOREIGN ARBITRATION AWARDS IN INDIA : DIMINISHING THE GAP BETWEEN PRE-BALCO AND POST BALCO REGIME?

The question of significance of arbitration as an alternate dispute resolution mechanism for disputes arising in M&A deals and other commercial arrangements is irrefutable and the same is fairly evident by the confidence which the market players across the globe have shown in this mechanism for resolving their commercial disputes. One of the major reasons behind the popularity of arbitration is the 'institutionalization' of arbitral mechanism, which has contributed significantly towards ensuring the goal of providing fair, impartial and formalized system of resolution of disputes without causing unnecessary delay or expense and at the same time providing the flexibility to the parties to exercise their freedom to agree upon the manner in which their disputes should be resolved, subject only to safeguards imposed in public interest. There are several international institutions with well-defined set of rules, which have succeeded in gaining the confidence of market players and are prominently preferred over the ad-hoc arbitrations.

One by-product of institutionalization of arbitration mechanism (which mainly involved foreign institutions and rules) is the issue of 'enforceability of foreign awards in India'. The said issue has been a subject matter of controversy and differential views since decades now. It is said that, under the Indian judicial system, a lot of times securing an arbitral award may only be half the battle won! Needless to say, such a proposition will certainly have a parasitic effect on the efficacy and reliability of the entire mechanism. The inconsistency in the judicial behavior on the subject has catalyzed this alarming concern. Even after the pro arbitration verdict by the Apex court in the BALCO case *[Bharat Aluminum Co. v. Kaiser Aluminum Technical Service]*, the prospective effect of the same somehow divided the entire issue into two uneven segments of pre-BALCO and post-BALCO regimes.

Pre-BALCO regime (prior to September, 2012): Position exiting Hitherto!

The BALCO judgment has been considered as a huge step till date by Indian judiciary towards ensuring the enforceability of foreign awards in India by overruling the prevailing verdict of *Bhatia International v Bulk Trading*. The ratio of the BALCO case can be set out as:

> Supreme Court recently in the case of *I-Max Vs E-City* has removed the judicial anomaly in relation to enforcement of foreign arbitral awards in India. The Apex Court in this case, overruling the popular Bhatia Judgment in relation to the agreements entered prior to BALCO Regime, held that the choice of ICC Rules and the consequent choice of London as the seat by the ICC operated as an exclusion of Part I of the Indian Arbitration and Conciliation Act 1996, thereby ousting the jurisdiction of Indian courts to maintain and entertain a challenge to the foreign award.

Part I of the Arbitration and Conciliation Act 1996 ("Act") shall apply to all arbitrations which take place within India and the foreign awards would only be subject to the jurisdiction of the Indian courts when the same are sought to be enforced in India in accordance with the provisions contained in Part II of the Act. Similarly, no suit for interim injunction would be maintainable in India with a seat outside India. Bhatia International and Venture Global Engineering [Venture Global Engineering Case v. Satyam Computer Services Ltd] and judgments following the interpretation are therefore over-ruled.

Having said this, somehow the applicability and significance of this judgment got restricted in its scope due to prospective effect of the binding judgment. Set out below is the relevant extract from the judgment for ready reference:

"The judgment in Bhatia International was rendered by this Court on 13th March 2002. Since then, the aforesaid judgment has been followed by all the High Courts as well as by this Court (i.e. Supreme Court) on numerous occasions. In fact, the judgment in Venture Global Engineering has been

rendered on 10th January 2008 in terms of the ratio of the decision in Bhatia International. Thus, in order to do complete justice, we hereby order, that the law now declared by this Court shall apply prospectively, to all the arbitration agreements executed hereafter."

Accordingly, post BALCO (i.e. after September 2012), there is no requirement of any specific exclusion of Part I of the Act and the Apex Court has unequivocally overruled Bhatia and Venture Global on the basis that Part I of the 1996 Act does not apply to foreign-seated arbitrations. However, the same was not made applicable to the arbitrations agreement entered prior to September 2012.

I-Max v E-City: a pro-arbitration move?

Finally, in the recent case of *I-Max Corporation v E-City Entertainment Private Limited*, the Apex Court considered whether to maintain a petition challenging a foreign award under Section 34 of the Act in India, under the pre-BALCO regime, which permits challenges to foreign awards in India unless the parties have expressly or impliedly excluded the operation of Part I of the Act and in its judgment while setting aside the position taken by the Bombay High Court, has significantly blurred this categorization and the position which stands out as on date can be summarized as:

The choice of institutional arbitral rules (ICC Rules in this case) and the consequent choice of seat by the arbitral institution (London) operated as exclusion of Part I of the Arbitration and Conciliation Act 1996, thereby ousting the jurisdiction of Indian Courts to maintain and entertain a challenge to the foreign award.

Setting aside Bombay High Court's view: The Bombay High Court recognized that there was no express exclusion of Part I of the Act in the arbitration agreement and it did not delve into the possibility of an implied exclusion by choice of the ICC Rules or the choice of London by the ICC Court of Arbitration as the seat of arbitration. Instead, it held that Part I of the Act was applicable to the Contract since there was no express exclusion. [Note that in addition to the question on choice of seat, Bombay High Court also held that Indian law will only be applicable law by "close nexus" principal irrespective of the contractually agreed 'Singapore Law' as the governing law under the agreement. However Supreme Court on the other hand clearly upheld the express choice made by two parties in choosing an unconnected law, i.e. Singapore Law, to govern the contract. The said issue was not debated much in the judgment and has not been specifically elaborated for the purpose of this Case comment.]

The Apex Court's verdict essentially brings out the following altered facets on table:

1. An arbitral institution's choice of seat, made in consultation with parties, was upheld as a valid and binding choice of seat in the absence of an express choice of seat.
2. This was recognized as exclusion of Part-I of the Act, for arbitration agreements entered into prior to the judgment of the Supreme Court in BALCO v. Kaiser Aluminum.

Note that in addition to the question on choice of seat, Bombay High Court also held that Indian law will only be applicable law by 'close nexus' principal irrespective of the contractually agreed 'Singapore Law' as the governing law under the agreement. However Supreme Court on the other hand clearly upheld the express choice made by two parties in choosing an unconnected law, i.e. Singapore Law, to govern the contract. The said issue was not debated much in the judgment and has not been specifically elaborated for the purpose of this Case comment.

3. Absence of pre-agreed foreign 'Seat' from the arbitration agreement: The Apex Court relied on specific procedures under the applicable ICC Rules [Refer to Article 14 of the ICC Rules] which permitted the ICC Court of Arbitration to fix the seat of arbitration unless agreed upon by the parties, after consultation with the parties. The court recognized the fairly unarguable presumption that the parties were aware that the ICC Rules contained provisions to fix a seat of arbitration. Thus, the choice of a foreign seat by the tribunal demonstrates the willingness of the parties to choose a seat outside India and thereby excluding Part I of the Act, consequently ousting the jurisdiction of Indian courts.
4. The distinction between pre-BALCO and post-BALCO is no more relevant and the progressive view of the Apex Court in BALCO judgment will hold

good even in a pre-BALCO regime wherein the choice of seat remained absent in the underlying arbitration agreement, while the chosen arbitral institution still provides for designating the seat of arbitration. The disputing parties in such a case will be in a position to exclude the operation of Part I of the Act where foreign seat is chosen by the arbitral institution.

ARA LAW View

The judgment is clearly a pro arbitration position by the Apex Court while removing all the inconsistencies and judicial anomaly in the views taken by the courts till date. For the agreements executed prior to the BALCO regime, the parties will not have to face the uncertainty of foreign awards getting amenable to challenge before the Indian courts in the light of Bhatia judgment which was applicable hitherto. It can be certainly said that with this judgment, the Indian judiciary has moved significantly towards the progressive arbitration regime from the existing regressive positions on the agreements entered in the pre-BALCO era. However, only the time will tell whether the position can be maintained as the final position or given the history of overruling judicial precedents, this one will also get surpassed by some contrary ruling!

[*SPACE FOR NOTES*]

LEGAL MISTAKES TO AVOID WHEN STARTING-UP

It has never been easy to do business in India, primary reason being its complex and extremely regimented legal system. Currently, the startup industry in India is at a very dynamic and unhinged stage with countless startups failing every year. With the advent of Prime Minister Narendra Modi and his ideas of ease of doing business in India, the ethos of doing business is changing slowly and becoming more lucid for start-ups. In his words, 'let the youth dream big and aim for the sky. The work of a government should be to open doors and boost up ease of doing business (in India)'.

However, mere flexibility in legal regime and additional benefits to incentivize the budding industry may not be sufficient to overcome various other common and yet repetitive mistakes by the entrepreneurs which, inter alia, attribute majorly to their fall. Start-ups, therefore must be diligent about a few common pit-falls – more specifically 'legal pitfalls'- before getting started. Although there could probably be an interminable list of such pitfalls, set out below are 7 obvious pit-falls in our experience that start-ups face during very initial days itself and should be meticulous about while starting up! This article intends to analyze the key essentials to be taken into consideration while investors conduct risk assessment for investment in AIFs.

FIRST, lack of mutual understanding between the founders or an 'incomplete founders' agreement' - The founder's agreement is the basic document in a start-up, something which comes into play even before the business actually starts. Primarily, it is a contract between the co-founders and defines the critical aspects of relationship between the co-founders like, inter-alia, ownership structure, business plan, initial investments, mutual rights and liabilities of the co-founders. Co-founders should be really careful while drafting and agreeing upon their mutual rights and obligations in the proposed start-up as the same will not only affect their se dealings but also has a direct or indirect impact on the assessment of the start-up by the future investors. Moreover, a non-exhaustive and ambiguous founders' agreement could even lead to dispute between the co-founders on various issues starting from commercial understanding to interpretation of the clauses. Therefore, it is always advisable that the founders' agreement should be properly drafted, negotiated and executed by the co-founders with the assistance of neutral and un-biased attorneys.

SECOND, suspending the 'structuring' of the set up and entities - A properly and well-structured set up is not only beneficial for the founders but also serves as a glooming option for the off-shore as well as domestic investors to invest their money in such a set-up. Start-ups should upfront structure their entities in a most tax efficient manner and avail maximum benefit under intellectual property laws (IPR) regime. It is common practice to structure the entities at different levels between off shore and domestic jurisdictions to reap out the desired commercial and legal results. Also, a lot of investors prefer to invest in the off-shore (holding) entities for various commercial and regulatory reasons. It is therefore advisable to work on the structure of the entities before commencing up and not to delay for future.

THIRD, failing to choose the correct 'business entity' - Once the inter-se terms between the co-founders are frozen and the structure is finalized, the next critical step is to choose the correct and most suitable type of legal entity to suit the business objectives on the one hand and be tax efficient on the other. The most lucrative types of business forms available to startup entities are a Private Company, which enjoys greater flexibility and less legal formalities; or One person Company, which is a private company with only one person as its member/director suitable for small entrepreneurs with low risk taking capacity; or a Limited Liability Partnership, which is a body corporate and legal entity with perpetual succession separate from its partners thereby bringing on table the advantages of a partnership and a limited liability company both.

FOURTH, working on 'gray' areas - It is truly said that the foundation of any start up and its fate depends upon the innovation of the underlying idea. However, a lot of times these ideas are not only unique but also

unprecedented and hence not envisaged by our law maker's decades ago while framing the legislations. Same goes well with the derivative models also or 'e-models' of the existing regulated businesses. Whereas, it is inevitable for the new and innovative business models to be ahead of regulatory framework, at the same time it is very important to work out the same without triggering any red flag under any directly or indirectly applicable law. Having said this, there could be critical business areas where 'silence of laws' implies 'prohibited or restricted' - like in the case of activities regulated by Reserve Bank of India (RBI). Therefore, going ahead with business models and ideas without a proper legal check of its viability may lead to unnecessary hurdles in future including imposing a complete ban or closure of such business by the authorities and also delays the targeted timelines by the investors with each of such issues being discovered and discussed upon during diligence exercise. Therefore, a proper regulatory and compliance check of the proposed business model vis-à-vis laws of the land is a must!

FIFTH, going ahead without a well framed 'Business Plan' - If idea is the foundation, the success of such an idea certainly depends upon the manner of creatively implementing the same into a reality. In precise words, a successful start-up demands an innovative idea followed by a robust business plan to ensure its desired implementation. Taking business plan as a mere formality or one of the documents in the bunch of initial stage documentation may lead to an indefinite implementation route with one more downfall story! The stories of money-spinning and unrealistic valuation figures are no more enticing for the investor of this generation unless supported by a viable and grounded business plan. Therefore, it is advisable to **have a well** drafted and mutually agreed business plan before starting implementing the idea. One brownie point- a good business plan lucratively attracts the investors too!

SIXTH, forgetting about the 'ownership of intellectual property rights' - If idea and implementation are important, then undoubtedly their protection is also equally important. A lot of times, the idea originates out of or in the course some other employment and therefore it becomes indispensable to scrutinize and ensure that the ownership of the IPR on the idea and business belongs absolutely and unconditionally to the founder(s) and/or other key managerial personnel only free from any possible claim(s) from any third party including any previous employer. It is advisable that the IPR attached to the business are properly registered as per applicable laws. Also, the prospective investors will always prefer to have the ownership over the IPR and work products in the name of the start-up only and not with the individual founder(s) or key managerial personnel. Hence the same should be assigned to the start-up, with necessary supporting documentations, by the owning members.

AND AT LAST, a loose attempt to be a *'lawyer in a deal'* - It is common for Indian start-ups to avoid any additional expense over and above the fund allocation for conducting business, marketing and raising further funds from the market. As a result, start-ups either end up engaging a non-expert or completely avoid taking legal advice on the matter including those which require proper domain expertise like foreign exchange laws, RBI regulations, employment laws and IPR registrations to name a few. Eventually it leads to an entity which has a big list of non-compliances including defaults which could trigger significant penalties as well. This assumes even more significance when it involves any cross-border element and may lead to several unwanted consequences in long or mid-term. One thing, which Indian start-up should give foremost importance is that no investor likes to invest in a defaulting or legally inviable entity. Therefore, start-ups should value their legal compliances as much as they do to their marketing factor. Equally important, is the legal assistance during winding-up process as well, to avoid any possible criminal or civil action as apparent from the much talked about recent cases in public domain. It is a common phenomenon under Indian scenario that, in the vague of engaging multiple advisors for different perspectives, start-ups fail to appreciate the prerequisite of domain expertise in legal field. In doing so, the start-ups lose out on advice from experienced legal counsel who can help better and there will be a chance of incurring lesser liability and serve as a desired target for the investors as well. The key here is to always engage a qualified and experienced lawyer with domain expertise to efficiently structure, keep a compliance check, lead the negotiation desk and successfully close the deal up to the satisfaction of the investors!

ARA LAW View

To conclude, while there could be numerous legal issues and pit falls for the start-ups before commencing their business activities BUT most of these issues are avoidable and a careful approach and diligence while dealing with these would certainly reduce the risks to a large extent. Going by this, afore mentioned 6 very basic- yet common legal mistakes by the start-ups if dealt in a systematic and as suggested manner, may possibly reduce the risk to minimal.

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'ISSUANCE OF CONVERTIBLE NOTE'- A BOOST FOR START-UP FUNDING

An entrepreneur without funding is a musician without an instrument

- Robert A Rice Jr.

In lieu of encouraging and enhancing the 'Make in India' initiative, the Indian Government to boost the Start-up's action plan, came out with the scheme of 'convertible note' by amending several regulatory laws for the effective implementation of this scheme. The arena of this scheme is to encourage start-ups by providing a way to raise money/fund for their business requirements via convertible notes for the investment at the initial stage of business

The Government of India in its endeavor to create a Start-up friendly environment introduced the Start-up Action Plan on January 16th, 2016 ("Action Plan"). The objective of the Action Plan was to build a strong Start-up ecosystem that nurtures innovation and encourages a Start-up friendly atmosphere.

As part of this flagship initiative, the Government introduced several tax exemptions, regulatory and compliance relaxations for Start-ups. One such initiative was to provide for issuance of 'convertible note' instruments by Start-ups for domestic and foreign investments, under Company and exchange control laws.

Whilst the concept of convertible notes for seed financing is fairly common in the US, this is the first time in India that statutory recognition has been provided to the issuance of convertible note instruments. Such convertible note instruments can only be issued by Start-ups and will act as a major boost to Start-up funding, by providing another venue for Start-ups to raise money.

CONVERTIBLE NOTE INSTRUMENTS

To this effect, amendments have been made to Company law and FEMA regulations under the Companies (Acceptance of Deposits) Amendment Rules 2016 and the Foreign Exchange Management (Transfer or Issue of Security by a Person Resident outside India) (Fifteenth Amendment) Regulations 2016 (collectively the "Amendment Regulations"), to include provisions for effective implementation of convertible notes.

These Amendment Regulations define 'convertible note' to mean an instrument evidencing receipt of money initially as a debt, which is either repayable at the option of the holder within a period of 5 years in a single tranche, or convertible into such number of equity shares of the start-up company, upon occurrence of specified events, as per the terms and conditions agreed and indicated in the instrument.

Convertible notes will, in effect, be akin to unsecured debentures or advance against shares, providing the holder of such convertible notes the option of recovering the amount within a period of 5 years from the date of issue of the convertible note in a single tranche or converting the debt into equity on pre-agreed terms.

The convertible notes can be issued only to eligible start-ups and can be issued for an amount exceeding INR 2.5 million or more only, in a single tranche. Also, issuance of convertible notes for foreign investments will require adherence to reporting, pricing, valuation and sectoral guidelines as set out under extant exchange control laws and the FEMA Amendment Regulations. Further, a Start-up issuing convertible notes to a non-resident must receive the amount of consideration by inward remittance through banking channels or by debit to NRE/FCNR (B)/Escrow account. The said escrow account should be closed immediately after the requirements are completed or within a period of six (6) months, whichever is earlier.

'Start-up Company' as per the Amendment Regulations will mean a private company incorporated under the Companies Act 2013 or the Companies Act 1956 and fulfilling the criterion set out in the notification issued by Department of Industrial Policy and Promotion ("DIPP"). Per the DIPP notification an entity will be considered as a 'Start-up' (a) up to 5 years from the date of its incorporation/registration; (b) if its turnover for any of the financial years has not exceeded 25 million;

(c) it is working towards innovation, development, deployment or commercialization of new products, processes or services driven by technology or intellectual property; and (d) if it is recognized as an eligible Start-up by the DIPP.

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The recognition provided to convertible note instruments under the Amendment Regulations will provide another venue for Start-ups to raise money for their business requirements via convertible notes. Issuance of convertible note instruments will also help solve valuation issues for Start-up companies looking for investments in their initial stages of business, as the option to convert the debt into equity at a later stage will help Start-ups justify the valuation for the investment.

However, even though a progressive move the fact that fund raising by issue of convertible notes can be done by eligible Start-ups only makes the implementation limited until such time that the Start-up is recognized as eligible Start-up by DIPP. To expand the benefits of convertible note instruments and its impact on increasing overall foreign investments it's applicability should be extended to other companies and domestic AIFs as well.

[SPACE FOR NOTES]

CORPORATE GOVERNANCE ISSUES IN LISTED COMPANIES – A NEED FOR REFORM?

In the past few months, we have seen Mr. Vishal Sikka resign from the board of Infosys – one of the largest Indian IT Companies – after a prolonged clash between the company's initial promoters and the board over Infosys' management policies. Not long before, we were privy to a similar issue on the board of Tata Sons – which resulted in the ouster of Mr. Nusli Wadia, one of the longest serving Independent Directors of Tata Group companies; and Mr. Cyrus Mistry, the first non-family chairman of the Tata Sons board. Lying beneath the surface of these corporate wars, however, are the broader questions regarding Indian corporate governance – which, perhaps well-equipped in letter falls short in spirit.

A brief look at Indian corporate history would bring to fore loopholes that have led to innumerable scams and governance failures, and reactionary legal changes introduced to tackle these deficiencies (most recent being the report by a committee chaired by Mr. Uday Kotak). However, even with multiple such checks in place, the situation appears as fragile as ever – with news of corporate governance failures having become a damning norm of the day. While challenges to corporate governance are as routine globally as they are domestically, and as grave across the unlisted space as they are to the listed, the scope of this article has been kept limited to the latter for the sake of brevity.

Recent Issues – Signs of weak Boards?

As dynamic as corporate governance issues be, one thing that can be said with certainty is that the board of a company plays a very important role in making or breaking a company's governance. As such, the events on Tata and Infosys boards have revealed certain fractures – one, how independent is the institution of Independent Directors in promoter-driven companies; and two, how tolerant is a board, of a company's management decisions, with regard policies on management's remuneration or related-party transactions?

Suffice it to say that removal of a director, including non-executive directors, from an Indian company requires only an ordinary resolution. While this power of the shareholders is an extension of the principle of shareholder democracy, it is questionable if its purpose is duly served. The Indian corporate landscape primarily consists largely of promoter-driven companies. In that, whether an ordinary resolution represents the will of all the shareholders uniformly is doubtful. *Recently seen is the instance of an Independent Director being removed from a board, wherein retail investors voted against the resolution for removal, but promoters (holding over 30% stake) requesting the removal, voted in favor of the resolution.*

Further, in a company where the promoter finds it easy to muster 50% of votes on a resolution with relative ease (as is often the case), it is only reasonable to ask as to how would an Independent Director ensure integrity in his actions if his position on the board is subject to collusion of a simple majority? And while the ability of a simple majority to move resolutions can be seen as furtherance of the *rule of the majority,* it is important also to see it from the point of board independence and practical limitations of such principles in the Indian context.

The other issue is the power of a board to challenge management policies – be it the severance packages of management executives or more generally, the say of management in a Company's affairs. Oftentimes, the same person heads the board as well as the management – a practice as local to newly found start-ups as it is to established corporate giants. It is here that questions regarding the strength of governance mechanisms start showing up again. A strong management may override the board – especially in corporations where the same person heads both the offices.

Need for Reform – Is the Anglo-Saxon Model fit for the Indian Company?

The Indian governance model is designed after the Anglo-Saxon model of governance. From the voluntary code floated by the Confederation of Indian Industry in 1998 to the recommendations made by *Birla and Narayan*

Murthy Committees, striking similarities can be drawn with the Sarbanes-Oxley Act, the Cadbury Report and other leading Anglo-Saxon corporate governance statutes.

The Anglo-Saxon models are, however, characterized by dominance of board of directors and shareholders as controllers, and the model is designed primarily to reconcile the conflict between the two. But while this model works well for more developed western jurisdictions, it is, as can be seen, not the best suited for the Indian corporate climate.

In typical Anglo-Saxon jurisdictions, corporate governance norms are aimed at disciplining the management and reducing the 'gap' between the management and dispersed shareholders. India, on the other hand, presents a more unique problem – the dominance of majority shareholders. Hence, perhaps the efforts towards corporate governance in India are aimed at the wrong gap. Secondly, Anglo-Saxon models are inherently designed at taming the over-powered boards in the West. India, again offers a different environment – wherein the rule of the majority shareholders prevails over that of the boards.

In that, it is only reasonable to ask – is it time we shift to some other model of governance (the Japanese, Continental, German being a few) or should we abstain from relying on foreign models for inspiration, and instead develop a more organic and relevant-to-India governance system?

Again, it is debatable whether the law needs a reform, or the participants need a healthier spirit. One problem with over-prescription of compliances and duties (as is the case in India), is that compliance gets limited to merely being a check-box exercise rather than a pro-active collective effort to adhere to the intent of the law.

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In the wake of these issues, SEBI issued a Guidance Note on Board Evaluation, prescribing the parameters against which a director may be evaluated. While the same may help in bringing more clarity regarding a director's performance in case he is removed – the utility of evaluation mechanisms is limited, given that there is no obligation to furnish reasons as to why a director's removal is being requested (LIC v Escorts[1986 AIR 1370]). It is also speculated that SEBI may seek amendment of the law in this regard – one of which may be by raising the voting requirement to a super majority.

Minutes of SEBI International Advisory Board Meeting show that the regulator has noted the corporate governance challenges in India. For a thorough review, SEBI also set up a 21-member Committee under the chairmanship of Mr. Uday Kotak to recommend changes to the governance framework in listed companies, which after almost 3 months and possibly a fair amount of scrutiny of the existing framework, presented its observations in a 177-page report in October 2017.

The main suggestions of the report – strongly dissented by the government and MCA – include having non-executive directors as chairmen of listed company boards; increasing the minimum board strength to 6 members, and minimum number of board meetings to 5 in a year; seeking public shareholder approval for remuneration of executive directors; disclosure of financials every quarter; stringent reviews by audit committee; splitting the offices of MD and CEO etc. (with the general opinion being that despite suggesting strong measures, the report seems to largely miss the mark with respect to empowering the office of Independent directors).

Although ideal, as has been seen in the past, such measures have not borne very fruitful results. One reason, as has been pointed out in this article, could be the undue reliance on foreign law, which at most times, does not seem to fit the Indian scenario. A second reason – more domestic – is a lack of pro-active desire for good governance.

It will be welcome if the regulators and legislators perhaps decide to move to a more practically suitable model to tackle the unique issues present in the Indian context. However, more welcome would be a change in the temperament of the corporate community itself – because governance is more a natural process than one which the law can command. A good ask is a balance of integrity, ethics and a strong value-system – but are our expectations too high?

CORPORATE GOVERNANCE NORMS FOR CLOSELY HELD COMPANIES: ARE WE ENCROACHING THE CLOSED TERRITORY?

Governance and leadership are the yin and the yang of successful organisations. If you have leadership without governance you risk tyranny, fraud and personal fiefdoms. If you have governance without leadership you risk atrophy, bureaucracy and indifference.

- Mark Goyder

There still exists certain dilemma on the applicability and mandatory applications of such norms on the private and unlisted entities and more specifically Micro, Small and Medium Enterprises (popularly termed as 'MSMEs'), which by virtue of their nature are closely held and translucent entities. This Article is an attempt to trace the development of corporate governance norms for such closely companies in India and link it to the eternal debate of flexible governing structure for such entities.

TO BEGIN, 'Corporate Governance' can be precisely defined as the system by which companies are directed and controlled with the responsibilities delineated amongst Board, stakeholders and auditors. In the words of Sir Adrian Cadbury, "Corporate governance is concerned with holding the balance between economic and social goals and between individual and communal goals. The governance framework is there to encourage the efficient use of resources and equally to require accountability for the stewardship of those resources". As said above, the concept and motive behind corporate 'good' governance is undisputable, however the applicability and need to balance the rights of stakeholders in a private company against the principle of liberal governance of private companies needs to be examined.

Regulatory framework of Corporate Governance in India: a quick Glance!

The regulatory framework and codes in India are majorly in sync with the international practise and standards like OECD Principles of Corporate Governance. The regulatory code primarily consists of the Companies Act (previously 1956 and now 2013), Securities and Exchange Board of India (SEBI) Guidelines, provisions of the listing agreement as per Section 21 of SCRA, Listing Obligation and Disclosure Requirements Regulation 2015 (LODR), MCA guidelines, Accounting Standards issued by the Institute of Chartered Accountants of India (ICAI) and Secretarial Standards issued by the Institute of Company Secretaries of India (ICSI). Further to keep up the pace with the dynamic regulatory requirements, the codes and guidelines are amended from time to time basis the recommendations of specialized committees appointed by the Government of the purpose like *Shri Kumar Mangalam Birla Committee and Narayana Murthy Committee* which gave us the Clause 49 of the listing agreement!

Issues of corporate governance have been fiercely debated across the globe since decades. India also has her own share of corporate governance moots and history of development – in order to reach a place where we stand as of now. The concept of corporate governance in India has been drawn and derived heavily on the British and American literature on corporate governance. However, unlike these jurisdictions, today we have reached a space where the significance and necessity of corporate governance has been consensually settled amongst the market players, stakeholders and the Government. Much of this owes to the lacunae in the system as exposed by the infamous Satyam Scam.

HOWEVER, as apparent from the above broad framework, until recently the erstwhile regulatory regime was focussed majorly upon the listed companies only. It is only with the advent of Companies Act 2013 ("2013 Act") that the private companies are brought within the purview of corporate governance norms in India. WHEREAS, the significance of corporate governance norms for listed companies is inevitable, much owing to the public and tradable nature of the securities, at the same time

the relevance of these norms for private companies can't be ignored completely. IN FACT, corporate governance can have wider impacts to the private companies because it is fundamentally about improving transparency and accountability within existing systems – something which has been a closed system till now and good governance mechanism will certainly help in gaining the confidence of stakeholders- specifically minority shareholders – of such companies.

Another vital aspect of corporate governance framework in India is the regulation of MSMEs. MSME sector is considered as the backbone of economy contributing to 45 % of the industrial output, 40 % of India's exports, employing 60 million people. Even with such a high proportion of employment and output, most of these enterprises are barely governed by any corporate governance norms. Reason being, the nature of incorporation of such entities- majorly in the form of unorganized structures, family units, partnerships or private companies. HITHERTO, corporate governance for MSMEs was primarily considered as the manner of improving business efficiency and performance, and less about monitoring the actions of management. However, with the changing market dynamics and regulatory coverage for different level of entities, there is a need to formalize the corporate governance structure of MSMEs as well.

Companies Act, 2013 – a Paradigm shift for Private Companies?

SEBI has always been a front runner while it comes to regulating the listed companies and corporate governance for the same. However, during the drafting of Companies Bill, 2013, the Ministry of Corporate Affairs (MCA) upon the popular feedback from the stakeholders and market players decided to incorporate the core governing principles of corporate governance in the Bill itself so as to include all type of companies- whether public or private and listed or unlisted- within the ambit of such norms. Accordingly, the appropriate best practices that were seen in Clause 49 of SEBI'S Listing Agreement and G20-OECD guidelines have been covered under the 2013 Act now. Some of the provisions even go beyond the requirements under Clause 49 and thereby giving rise to the need of making suitable amendments to Clause 49 to make it further consistent with the 2013 Act. Needles to mention, some of these norms are applicable only to public or specified class of companies thereby maintaining the general principal of higher degree of governance requirement for such companies.

THEREFORE, there is a clear move towards closely monitoring unlisted public companies and private companies with boosted compliance requirements encircling disclosures, transparency and governance procedures. Another important facet to be noted here is that while the block for corporate governance for the private and unlisted public companies has been raised, the penal consequences have been exponentially increased too with penalties ranging from monitory fines to imprisonment of officers in default as well. The move can be said to be a bold initiative towards strengthening corporate governance amongst the private and unlisted companies and to keep a strict check over the activities of companies in order to save the interest of the shareholders like earlier done for publicly traded companies.

Accordingly, the private and unlisted companies are now mandatorily required to comply with the good governance norms like, enhanced role and responsibilities of the Board; periodical disclosures relating to the financial and commercial transactions. remuneration of directors, etc.; codification of duties of directors; approval of related party transactions by the audit committee; 2% of profits to be spent by eligible companies on corporate social responsibility and separate section in annual report on compliance with Corporate Governance.

HAVING SAID THIS, it is to be noted that the key introductions under the 2013 Act – including the requirement of independent directors on Board - have been reserved for listed and public companies only. Thereby, keeping the Board of such private and unlisted companies as 'closed' only.

Corporate governance is undoubtedly relevant to organisations of all sizes and nature of incorporation. Nonetheless, the aims and nature of the corporate governance framework applied are likely to vary from one type of company to another. Accordingly, the provisions introduced under the 2013 Act and critical once *inter alia* more specifically listed out herein below should be made applicable to private companies as well

with suitable exemptions and modifications so as to suit the requirements and nature of private entities:

Board Composition - The norms on introducing independent members and neutrality is an important element of corporate governance, certainly for larger, listed companies, but is required for private companies as well. Most businesses do not exist in a static state, but are constantly evolving. For this reason, the role of the board also needs to evolve over time. As the firm matures, the greater the need to bring in outside directors. The proportion, liabilities and qualification criteria of such directors could vary, but the requirement should very well apply to all type of companies. The recent Companies (Amendment) Bill of 2017 proposes to make the requirement of compulsory corporate social responsibility committee in case there is no requirement for the appointment of independent directors. However as understood the same may not be relevant for the purposes beyond the social responsibility and hence the need of independent directors on Board remains intact!

Committees under Board - The committees like Audit Committee, Risk Management Committee, Nomination & Remuneration Committee and the Stakeholders Relationship Committee introduced by the 2013 Act are applicable only for certain categories of companies and beyond the threshold requirements. Considering the relevance of such committees in bringing a fair process and keeping a check on the governance norms, the same should be extended to other companies as well with flexible process and liabilities.

Removal of Directors - suitable governance norms and fair process for removal of directors (including independent directors) along with a reasoned decision for such a decision by the promoters driven Board in privately held companies should be included.

Disclosure Requirements - Filing of annual return and enhanced disclosure norms in relation to disclosure on related party transactions, remuneration policy, accounting norms, vigil mechanism, report of corporate governance, etc are again applicable on certain set of companies- primarily public and listed companies. In order to increase transparency in the system, suitable disclosure norms (at least a report on corporate governance measures- voluntary or mandatory) needs to be made applicable on all type of companies. The recent Companies (Amendment) Bill of 2017 has proposed certain disclosures on stakeholder's interest on be made on website instead of Board's report and is certainly a welcome step, however the same is again applicable of public listed companies only and hence demands the appropriate extension to private companies as well.

Whistle Blower Policy - In line with the provisions of vigil mechanism as specified in section 177 (9) of the 2013 Act, the requirement should be made applicable to private companies with a threshold turnover.

Specific Governance Norms of MSMEs?

The MSME Act of 2006 is completely silent on the corporate governance aspect except it gives the power to the Government to formulate regulations and guidelines for management and employee development. However, till date nothing major on the domain has been initiated by the Government as well. Corporate governance in large businesses is associated with the agent-principal issue, however in MSMEs the agent-principal issue is less likely to arise, or less likely to be so significant considering the gap between ownership and management hardly exists. This results in poor governance norms and a question mark on the interest of the other stakeholders (other than those forming part of the management group). THEREFORE, for the MSMEs which are incorporate other than as private companies, the issues of corporate governance are of utmost importance now.

Other than the aforesaid inclusions, certain MSMEs specific governance norms need to bring in to the system. There is no universally approved standard model of corporate governance for MSMEs. Nevertheless, there are various international models and authorities like OECD and the European Confederation of Directors Associations (ECODA) which should be used as the foundation stone for our own comprehensive code on corporate governance norms for MSMEs. Further, existing frameworks need to be applied flexibly, taking account of the heterogeneous nature of MSMEs. AMONGST OTHERS, flowing should be the basic governance norms to be formalized for the MSMEs, adopting a formal corporate governance framework outlining the roles of the key bodies such as partners, shareholders, Board of Directors and management; Establishing a

timely, open and transparent flow of information with shareholders; Developing a clear mandate for its Board of Directors to oversee the operational performance of the business as well as evaluating and improving business strategies; Norms for segregation of management and ownership units with a neutral governing body; Auditing of books of accounts by external auditor; Setting up an internal control framework in place and conducting a regular review of risk; Timely disclosures of financial and governance report of the entity to the stakeholders.

Balanced or still lacking?

Stepping back and looking at the arc of regulatory changes, the need for codifying corporate governance norms for private and unlisted companies is well founded. Same applies to a great extend to MSMEs as well. Further, the common view that corporate governance, especially for closely held companies, is something one cannot regulate and should be voluntarily done does not hold good in present times when there are multiple examples of abuse of such voluntary principals available in public domain. CERTAINLY, the 2013 Act and provisions for corporate governance which attempts to strike a balance between rights of shareholders and responsibilities of the company, were the need of this hour and we have not encroached or surpassed the boundary in any manner. Now the next question arises, whether we are still lacking behind? To an extent – Yes! While the 2013 Act is a much-needed piece of legislation on corporate governance, however in order to maintain the supremacy of the closely held structure and relaxed governance norms for private and unlisted companies and specifically MSMEs, somehow the lawmakers inevitably decided to keep the breakthrough requirement of promoting fair functioning of the Board by presence of independent directors and other major corporate governance measures have been kept away from the closely held companies. Going on this track, yes, we are much ahead of previous times BUT lacking a major step behind!

ARA LAW View

A much talked about regulatory dilemma is that of balancing the rights of minority shareholders against the principle of maintaining flexibility for the private and closely held companies. The 2013 Act is a fairly reasonable attempt to bring such companies in the ambit of corporate governance norms and thereby bringing the much-needed balance. However, to avoid the misadministration and abuse of law in MSMEs, private and unlisted companies (where the visibility is much lesser than the public and listed companies!), it is still required to go few steps ahead and make the stricter provisions under Clause 49 applicable to them as well – if not all then at least the critical ones. Whereas, the recent Companies (Amendment) Bill of 2017 has made far reaching changes to the current 2013 Act, however the need of inclusion of good governance norms to closely held companies is still away from the ambit of proposed changes. Independence of Board, manner of removal of directors, making whistle blower mechanism a compulsory requirement, enhanced role of audit committee and fiduciary duties of major shareholders are some of the areas where not only private and unlisted companies but also MSMEs should step in now!

[*SPACE FOR NOTES*]

DEBT IMPLICATIONS VIA THE COMPANIES (AMENDMENT) BILL 2017 – ANALYSIS FROM A DEBT ANGLE

The Companies (Amendment) Bill 2017 (the "Bill"), which was passed by the Lok Sabha on July 27th, 2017, seeks to make a number of changes to the current form of the Companies Act, 2013 (the "Act") to achieve the Government's twin objective of improving the ease in doing business in India and ensuring better corporate governance by companies. This article seeks to examine some of the major changes proposed in the Bill, which is pending before the Upper House, specifically from a debt financing point of view.

1. ***Narrow scope of 'Debentures' –*** The Bill seeks to amend the definition of the term 'debentures' in the Act to exclude (i) the instruments referred to in Chapter III-D of the Reserve Bank of India Act 1934, which include derivatives, money market instruments, repo and reverse repo instruments and securities of the Central Government, a State Government or such local authority(s) as may be specified by the Central Government; and (ii) any other instruments that maybe prescribed by the Central Government in consultation with the Reserve Bank of India. This exclusion was sought as the current definition is very broad and seems to include certain short-term funding instruments which are already well regulated under current RBI regulations. The proposes amendment seeks to harmonize the different laws and avoid overlaps.

2. ***Re-haul of the private placement mechanism –*** The entire section 42 pertaining to private placement of securities has been replaced making the process slightly simpler. The following are some of the changes that have been proposed by the Bill:

   a. **'Identified Persons'** – The Board of Directors are required to identify the select group of persons to whom the private placement is proposed to be made. This would make the issue much more transparent and specific.

   b. **Offer-cum-application letter** – The Bill has done away with the exercise of furnishing serially numbered application forms to each allottee along with the private placement offer letter in Form PAS-4, thus simplifying the process and reducing the time involved. The format of this form is also expected to be rehashed to a leaner version.

   c. **No Right to Renounce** – It has been expressly clarified that the private placement offer and application (Form PAS-4) cannot carry a right of renunciation as is the case with the offer letters in a rights issue. This prohibition has been added in light of the market practice of incorporating the renunciation right in the application forms which effectively circumvented the idea of a privately placed issue. This move will improve transparency regarding the final investors.

   d. **Conditions to utilize proceeds** – A new stipulation in the Bill mandates that the issuing company can utilize the monies raised through private placement of debentures only after (i) the debentures have been allotted; and (ii) the return of allotment in Form PAS-3 has been filed with the Registrar. This amendment will ensure that if the issue fails, investors will have their monies redeemed before they have been utilized. For companies in urgent need of funds raising money via interim/ bridge funding through a private placement process will be difficult.

   e. **Simultaneous Issues** –To the provision under the Act that no fresh private placement offer can be made unless earlier allotments have been completed or withdrawn by the company, the Bill now seeks to carve out an exception for a certain class of identified allottees (to be subsequently prescribed), to whom multiple issues by means of a private placement can be made at the same time, subject of course to the maximum thresholds of 50 (per issue) and 200 (overall) as specified

in the Act. This exception seems to have been made to enable companies to simultaneously keep open more than one issue of securities to the class of identified investors, in order to provide greater flexibility in raising capital/loans while not compromising on regulatory concerns.

f. **Stricter Return of Allotment Procedure** – The period of filing the return of allotment in Form PAS-3 has been reduced from 30 to 15; the Bill has also now introduced a specific penalty on the company, promoters and directors for failure to file the return of allotment – provisions that will ensure stricter compliances.

g. **Change in Penalties** – The penalty provision for an offer made in contravention of section 42 has been revised to the lower of a) *amount raised through private placement;* or b) INR 2 Cr, as opposed to the extant position viz. higher of a) amount involved in the offer or invitation; or b) INR 2 Cr. This seems to suggest that, in case of breach, the penalty would be restricted to an amount of INR 2 Cr or even lesser, as opposed to the earlier position which could go up to the entire amount stipulated to be raised. Additionally, the Bill imposes the liability of refunding the monies to the identified persons/allottees with interest at the rate of 12 % per annum, which is not currently envisaged in the Act.

3. Fewer Filing Formalities –

a. Clarifications regarding resolutions to be filed with RBI – The Bill proposes to do away with the obligation on companies under Section 117 (e) to file with the Registrar, a copy of resolutions passed by it pursuant to Section 180(1)(a) and 180(1)(c) – pertaining to limits on security creation and borrowing powers, respectively – as the same are sub-sets of Section 117(a) (which requires a company to file all special resolutions with the Registrar).

b. Exemptions to Banking Companies– Banking companies are proposed to be exempt from the requirement to file with the Registrar in Form MGT-14, resolutions passed by the Board under section 179(3) of the Act if these resolutions pertain to granting of loans, or giving guarantee or providing security in respect of loans, if done in the ordinary course of business.

4. Changes/ clarification of thresholds for borrowing and security creation –

a. *Increase of borrowing limits* – Under Section 180(1)(c), the Bill proposes to increase the threshold for seeking shareholders' approval to borrow money, by including securities premium account in calculating the upper limit of borrowings that can be made without such an approval. This in turn increases the quantum of the benchmark, which would ease the capital raising process.

b. *Clarification regarding quantum of loans and investments* – Although already provided for in the Companies (Meetings of Board and Its Powers) Rules 2014, the Bill clarifies expressly that the amount of loans and investments made so far, and the amounts for which guarantee, or security have been provided in the past also have to be clubbed with the loans, investments, guarantee and/or security proposed to be made/provided, in calculating the limits with respect to the same provided u/s 186(2).

5. Simpler regime for loans and investments made by companies –

a. Exemption for loans given to employees – The Bill seeks to incorporate that a company need not watch out for the threshold set under section 186(2), and hence need not pass a special resolution in case this threshold gets breached, while giving loans to, or giving any guarantee or providing any security in connection with any loan provided to an employee of such company.

b. Maximum limits of loans not to apply on WOS – No special resolution needs to be passed u/s 186(3) if any loan or guarantee is given or where security has been provided by a company to its' wholly owned subsidiary ("WOS") or a joint venture company, or if an acquisition is made by a holding company by way of subscription, purchase or otherwise of securities of its WOS.

c. List of exemptions expanded – Section 186 (11) lists the entities that are exempt from complying

with the provisions of section 186 (except sub-section 1). The Bill has substituted 186 (11) to now exempt 'investments' (as opposed to 'acquisitions') – (i) made by 'investment companies' (as opposed to the current 'companies whose principal business is acquisition of securities') (ii) made by a company in a rights issue of another company, and (newly added) a rights issue of any body-corporate; and (iii) made by an NBFC whose principle business is acquisition of securities, (newly added) specifically in respect of investment or lending activities;

Further, the definition of 'investment companies' has been expanded to suggest that its assets in the form of investment in shares, debentures or other securities constitute not less than 50 % of its total assets, or if its income derived from its investment business constitutes not less than 50 % of its gross income.

ARA LAW View

It appears that the Bill aims at improving ease of doing business in India, easing the fund-raising process to provide fast capital to companies (and especially to start-ups) and enhancing corporate governance by aligning provisions of the Act with SEBI regulations. Processes relating to issue of debentures will also turn out to be a little easier, transparent and accountable – measures like doing away with certain resolutions for their issuances, merging the private placement offer letter and the application to allottees, expanding the benchmark for borrowing funds and allowing simultaneous private placement issues etc. will be advantageous to companies issuing debentures on a private placement basis. Simultaneously, exclusion of renunciation rights, bar on utilizing monies raised by a private placement before actual allotment, and specific penalties in place for failure to duly file returns of allotment are some measures, which if incorporated, would ensure that companies raising funds grow closer to better corporate governance and accountability.

[*SPACE FOR NOTES*]

FUNDING – WHY DEBT IS THE WAY AHEAD

Start-up funding has traditionally been equity focused, and logically so – keen institutional investors would be willing to part with their funds only against some control over the business they put their money in. However, with equity-financing being constrained for some time now, start-ups have started to look towards alternative sources to raise capital, and non-convertible debentures (**NCDs**) have proven to be the most preferred instruments for entities seeking bridge or short-term funding. In fiscal 2016-17 in fact, corporates in India raised upwards of INR 58,000 Cr. through these instruments – significantly more than numbers seen in the last 5 years. In this article, we explore why and how pure debt instruments are the new object of start-up market desire, and why this trend is here to stay for a long time to come.

The Case FOR Debt

Venture Equity Crunch

Most of the VC funds in the country follow the traditional equity-investments-only approach. However, the past couple of years have seen a slow-down in the scheme of things for a variety of factors – the mushrooming of start-ups, and multiple players in the same space; the burst of the online tech start-up bubble; geo-political events like Brexit; etc – which have impacted capital inflows and made equity-raising difficult. The converse interest in debt is also evidenced by the increased FPI activity in Indian corporate bonds, as seen when the combined corporate debt limit of INR 443,833 Cr. was almost entirely allocated to foreign investors. Further, Prime Database records show that mobilizing funds through NCD issuances – private or public – was the most preferred route for Indian corporates in the first half of 2016-17.

Banking Infrastructure un-favorable to Start-ups

Another big factor that has made (and may make more) start-ups look towards NCD-funding is the lack of efficient support from formal banking channels. Most banks lend against collateral and hence shy away from lending to asset-low start-ups. In that, it is extremely hard for start-ups in early stages of their life cycles to furnish proper resources to bank. Unsecured loans at high interest do not make for viable alternatives. Hence, the most lucrative option remains an NCD issuance. In the past 5 years, a number of big and small players in the e-commerce ecosystem have done such issuances. And although still relatively small in number, the space has also seen incidence of purely debt-focused venture and private equity funds.

Easy Bridge Funding Solution

Start-ups need a lot of short term financing at a lot of times. Sharing equity cannot be the solution every time some funds are required at immediate disposal. Neither is it easy to find investors to pump in small sums of money against high-risk equity instruments. On the other hand, NCDs prove to be the best alternative for such bridge funding rounds. While investors can expect better returns for short-term loan solutions and investees can have the funds they need through processes relatively cheaper, easier and convenient than equity issuances – and hence, a lot of venture debt investments usually take place between Series B and C equity funding rounds, with a typical ticket size being anywhere between INR 2 Cr. to 50 Cr. for four to five years.

Investor Friendly Instruments

With often higher rates of return than equity, low redemption and maturity periods, and no element of corporate obligations attached to equity-holding, NCDs are attractive instruments for investors not seeking long-term investments in a company. Further, most debt issuances are secured, thereby giving a degree of comfort to the investor parking funds. Again, in case the investee company does not manage to survive in the competitive start-up space, lenders will have a stronger claim against equity holders during winding-up. Also, most NCD issuances are short-term, hence investors not looking to be invested in the markets for long, can usually exit with attractive returns in relatively smaller durations than equity investments commercially allow. Again, for people

in the median tax bracket of 10% - 20%, NCDs with their high yields provide better tax efficiency than other bond market instruments like zero-coupon bonds, fixed deposits or government bonds.

Policy Support

In the last few years, a lot of government initiative has been towards allowing start-ups easy access to funds – be it equity or debt. However, as mentioned above, with equity funding constrained, most policy measures will ease debt funding options for investors. Further, the Companies Amendment Bill 2017 provides for easier private placement mechanisms and increased borrowing limits for companies, again, making debt an attractive choice for investors. Further, public issuance rounds of debt instruments, reasonably, are easier and shorter than equity rounds – with fewer and less onerous compliances like a promoter lock-in, or profitability of 3 years etc. for all the participants as opposed to an IPO/FPO or other equity raising round.

The Case AGAINST Debt

Having made a case for debt above, it is only fair that we point out a few pointers that investors may need to keep in mind before and after their investments. First being the problem of liquidity. Pure debt instruments, especially listed NCDs, have seen a lot of fervor from market participants in the recent past and are considered highly liquid instruments – the same, however, cannot replace the liquidity that equity of a well-performing corporate does. Second, investors need to keep in mind that these instruments only accord them the status of a creditor to the company, and not of owners – hence, they will have no say in policy and management decisions of the company.

ARA LAW View

NCDs, with their attractive returns and low-risk nature, indeed do present themselves as very viable instruments for investments. As stated in the article, several venture capital firms focused solely on debt funding have emerged in the last couple of years. However, the situation is not entirely free of a few riders. Debt funding can never replace the position of equity funding. Equity funding rounds exhibit a far greater level of potential of any corporate – so much so in fact, that a lot of venture debt funds only lend to those companies that are backed by strong equity investors. That at times negates the entire point of debt funding. We do, however, have seen activity from a lot of funds that have recognized potential in early-stage start-ups and assisted them even when the equity backing has not been very strong. Another red flag, or rather a situational hazard, as pointed out in this article is that debt instruments can never provide the same level of control over an entity that equity does – hence investors looking to have some control over policy and management decisions of the company may shy from debt funding. The same can be acknowledged by the dearth of formally debt-focused funds in the country. In the coming days, however, we expect a lot of activity in venture debt funding space and can predictably see a lot of institutional players come up, as well as a lot of start-ups adopting the debt route for their capital requirements.

[*SPACE FOR NOTES*]

INVESTING IN LISTED NON-CONVERTIBLE DEBENTURES – HERE IS WHAT YOU NEED TO KNOW

The broad regulatory and legal framework applicable to issuance of listed debentures largely consists of the Companies Act 2013 (Companies Act) read with the Companies (Share Capital and Debentures) Rules, 2014 (Share and Debenture Rules), the SEBI (Listing Obligations and Disclosure Requirements) Regulations 2015 (LODR Regulations) and the SEBI (Issue and Listing of Debt Securities) Regulations, 2008. Depending on the sector and the nature of investors other RBI and SEBI regulations would also apply.

The broad regulatory and legal framework applicable to issuance of listed debentures largely consists of the Companies Act 2013 (Companies Act) read with the Companies (Share Capital and Debentures) Rules 2014 (Share and Debenture Rules), the SEBI (Listing Obligations and Disclosure Requirements) Regulations 2015 (LODR Regulations) and the SEBI (Issue and Listing of Debt Securities) Regulations 2008. Depending on the sector and the nature of investors other RBI and SEBI regulations would also apply.

Eligible Investors: The primary consideration for an investor is to determine whether it qualifies as an eligible investor. Various categories of domestic and foreign investors are permitted to invest in listed NCDs, subject to their respective regulatory regime. In terms of domestic investors resident individuals, corporates, Alternate Investment Funds (AIF), Mutual Funds (MF) and Non-Banking Financial Institutions (NBFC) are permitted to make investments. As for non-resident investors, Non-Resident Indians, Foreign Portfolio Investors (FPI) (the FPI regulations have subsumed the Foreign Institutional Investor and the Qualified Foreign Investor regime) and Foreign Venture Capital Investors (FVCI) are permitted to invest in listed NCDs. Some of the commonly used routes to infuse foreign debt (other than external commercial borrowings) include purchase of listed NCDs under the FPI route and NCDs which may not necessarily be listed under the FVCI route. The FPI regulations also prescribe a minimum maturity period of three (3) years for investments in listed NCDs.

Investment Limits: Corollary to the above, eligible investors will also have to be mindful about investment limits applicable to them. The limit for total foreign investment in corporate debt in India has been set at USD 51 billion which was redefined as the Combined Corporate Debt Limit. However, specific limits are also applicable to certain investors, for instance, the FPI regulations limits a single FPI or an investor group from purchasing above 10 % of the total issued capital of an Issuer. Similarly, limits on investments have also been prescribed for MFs and AIFs and minimum capitalization conditions also apply to FVCIs. Investee companies will not necessarily have the knowledge regarding eligible investors, therefore regulatory awareness about the ever-changing regime regarding limits and pre-conditions is essential, even before chalking out the investment strategy.

Credit Risk: One of the prime factors that should be considered is the creditworthiness of the Issuer and its ability to service the debt through its cash flow. There can be various factors affecting the financial health of the Issuer that can have an impact on the creditworthiness of the Issuer. A business due diligence on the Issuer can be done identify such factors, relating to the assets, debt equity ratio, receivables, valuation of assets, profitability, cash flow, bad credit history, net worth, inventory, other market conditions etc., which should help ease concerns with regards to any credit risks.

Security Risk: Listed NCDs are usually secured (by way of pledge, mortgage of property, hypothecation of receivables etc.) in favor of the debenture trustee who holds the position in fiduciary capacity on behalf of the NCD holders. Typically, it is not uncommon that the charge created would be a second charge on the assets of the Issuer, from an enforceability perspective, this is a riskier option with respect to seniority of debt, if possible a first and/or a pari passu charge should be

created over the assets of the Issuer (a charge can also be created over the assets of the company's subsidiaries or its holding company or its associate companies) as this provides priority to the investor's debt, at the time of liquidation. Creating an English mortgage would be the preferred option, since the assets remain in possession of the debenture trustee, until the repayment of the principal amount.

Enforceability Risks: Under the Insolvency and Bankruptcy Code 2016 (IBC Code) *any financial creditor* to whom financial debt is owed, including an FPI, can seek recourse under the IBC Code. However, once an Insolvency Resolution Process (IRP) has been initiated, an Adjudicating Authority (AA) can by order, prohibit the institution of suits for recovery of any property or enforcement of security interest by a debenture holder, including any action under the Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest Act 2002. If the IRP fails or is not completed within the prescribed period, the AA can direct the Issuer to be liquidated. As mentioned earlier, adequate security covers at a first charge and/or pari passu basis becomes imperative during the liquidation process, as secured creditors are placed higher on priority over preference and equity shareholders.

Risk of Improper or Inadequate Documentation: When speaking about enforceability, the documentation and drafting of the Debenture Trust Deed (DTD)/ Debenture Subscription Agreement, Debenture Trustee Agreement (DTA), and the security documents becomes critical. It is important to ensure that the agreements are carefully crafted and adequately stamped and registered, to protect the investor's interest and to ensure a smooth transition at the enforcement stage. The DTA should clearly outline the intention, purpose and creation of the trust, rights, duties, responsibilities, also ensuring good corporate governance policies along with liability of and indemnity towards a trustee. The documentation primarily needs to be sound in terms of the Indian Contract Act 1872, Transfer of Property Act 1982 and the Indian Trust Act, 1882 (Indian Trust Act). For instance, certain provisions of the Indian Trust Act are required to be incorporated into the DTD, while also being mindful about arbitrability of the DTD, as the recent Supreme Court judgement has shown, disputes arising out of Trust Deeds and the Indian Trusts Act cannot be referred to arbitration.

Regulatory Risks: Along with the requisite SEBI regulations and provisions of the Companies Act that are mandatorily required to be adhered to by the Issuer, entities in highly regulated sectors are additionally required to comply with multiple regulations, restrictions and regulatory bodies overseeing their functioning (ex. NBFCs, entities in pharmaceuticals and healthcare). A prior *legal due diligence* of the Issuer is paramount to understand the regulatory regime that it operates under, to ensure that the company is compliant and has been complying with regulatory and statutory obligations.

A legal, business and a financial due diligence becomes mandatory in relation to additional risks, that become incurable to the investor's investment at a later stage, including ongoing litigation either against the Issuer or its promoters/directors, restrictive covenants/prior consent requirements from existing lenders for creation of security/ accepting additional debt, contingent liabilities, ability to sustain positive and profitable growth, inflation, and inadequate insurance coverage against default/losses. The diligence exercise ensures that the investor is aware of all the contingent liabilities and non-compliances before the investment is made. The Issuer can then be directed towards remedying such risks/issues. For instance, ongoing disputes due to non-payment of income tax dues can have an adverse effect on the security created, in the event that the income tax authorities attach the assets of the Issuer.

Liquidity Risk: Most NCDs are listed on the stock exchanges and are available in de-mat form. Although this means they are liquid, the fluctuating interest rates make exiting/selling NCDs through the secondary market difficult, wherein, if the interest rates are high, the value of the NCDs will consequently fall below its face value at times. Due to challenges relating to liquidity, there are also few buyers of listed NCDs on the market. It is difficult to control and predict the markets and it consequent effect on the listed NCDs, however, other risks associated with listed NCDs can easily be mitigated with the measures mentioned above, to ensure that unavoidable risks such as liquidity risks do not cumulate with other risks.

Tax Implications: Tax implications play an important role in determining one's investment strategy. Under the present Indian tax regime there is no tax deduction at source on payment of interest for listed NCDs (except payments/issuance under Section 193 of the Income Tax Act 1961). Also, any interest so earned will be taxable as per the relevant tax slabs of the investor. Any sale of listed NCD within a year of subscription will be subject to Short Term Capital Gains Tax (STGT) and sale after one year will attract Long Term Capital Gains Tax (LTGT) at 20 % with indexation and 10 % without indexation. For NRI investors, NCDs purchased in convertible foreign currency is taxable at 20 % and the LTGT is taxable at 10 % of the capital gains arising without indexation of the acquisition cost. However, STGT are taxed at normal tax rates.

Foreign investors should structure their investments based on tax feasibility, keeping in mind implications and advantages in various tax jurisdictions to mitigate tax leakage with regard to capital gains tax and tax withholding on interest payments. The recent changes to the Double Taxation Avoidance Agreement (DTAA) with Singapore and Mauritius, shows a shift towards source based taxation of capital gains from April 1, 2017 at 7.5 % and the same will be completely done away with from 2019 onwards. Further, Netherlands seems to be emerging as the next favorable destination for investors in search of tax benefits, as the DTAA with Netherlands has not been amended and also local tax is only levied on business income and not on capital gains (subject to conditions of course!).

ARA LAW View

Along with the mitigation of risks through adequate documentation and due diligence exercises, investors can also rely on the provisions of the Companies Act and SEBI Regulations to protect their investments. For instance, the LODR Regulations mandates for maintaining a 100 % asset cover, sufficient to discharge the principal amount for the NCDs, at all times and prior approval from the stock exchange is required for any changes concerning the structure of the listed NCDs, in terms of redemption, or otherwise. Listed entities issuing NCDs are required to submit yearly/half yearly financial results and disclosures relating to credit rating and change in credit.

Issuance of NCDs can be beneficial for both parties involved, from an Issuer's perspective they offer advantages such as the interest paid on NCDs can be claimed as an expense against its profits and it also maintains the shareholding pattern of the Issuer without diluting shareholding, while also raising capital. If the risks are pre-mitigated with the proper measures taken before and during the investment, from an investor perspective, the prime advantage of investing in debentures are the fixed and stable return with preferential rights of payment at the time of liquidation. Given the volatility which equity markets have consistently witnessed coupled with the advantages that NCDs offer both to the Issuer and the investor, listed NCDs are fast emerging as a safe and a viable investment alternative.

[*SPACE FOR NOTES*]

CRITICAL INGREDIENTS TO BE ACQUAINTED WITH BEFORE INVESTING IN AN ALTERNATE INVESTMENT FUND

In the past year the market has seen a sharp incline in investment by over 90 % in Alternate Investment Funds (AIFs). The main reason is increased awareness and shift from traditional methods of investment by High Net Worth Individuals (HNIs) intending to invest in high yield and structured AIF space. This has even prompted the Government to come up with various incentives and liberalization for AIF regime to give a boost to the industry. This article intends to analyze the key essentials to be taken into consideration while investors conduct risk assessment for investment in AIFs.

There are various factors, ranging from legal and fiscal to contractual and commercial, which are relevant for an investor to be well versed with before opting to invest through AIF route. Without undermining the significance of remaining, set out below are "7 critical" checks which an investor must make prior to its investment:

A Robust and Unambiguous Founders Agreement - An AIF structure consists of different ancillary parties i.e. Investment Manager, Sponsor and Trustee. The Investment Manager (who can also be the Sponsor) is an individual or entity appointed by the AIF to manage the investments. It is a common practice that Investment Manager is incorporated as a LLP for ease of governance reasons. For an investor, it is necessary that the Investment Manager has stable, exhaustive and ring-fenced agreement to assess the day to day conduct of the manager to fulfil its responsibilities towards the AIF and govern the inter se arrangement between the partners and key members. It is therefore necessary that a robust founders' agreement establishing the relationship between the partners in case of an LLP be in place. This is necessary to avoid any future disputes associated with role, responsibilities and remuneration of the key management team considering the same may impact the performance and management of AIF and in turn the investors also long run. In case, the Investment Manager is incorporated as a company, exhaustive individual employment agreement(s) together which a common inter se shareholder's agreement should be in place.

Independence of Trustee and other key parties - The trustees role under the AIF Regulation though not iterated we can derive the same from the Indian Trust Act wherein the trustee has been appointed to protect the trust and not create any adverse title as against the beneficiary and further, on analyzing its role under the Real Estate Investment Trust or Infrastructure Investment Trust regulations we note that the role is to oversee the managers activities and operations, thereby creating a fiduciary capacity imbibed with liability. Therefore, it would be recommended to uphold the autonomy of the Trustee to act as guardians of the AIF to protect the investors interest and to have a neutral and independent trustee instead of a related entity. In case the trustee entity is related to Investment Manager or AIF, it is always advisable to have a distinct board composition or a separate decision-making authority (as may be applicable) so as to maintain the investors' confidence on the impartiality of the board and its decisions.

A Comprehensive Investment Committee (IC) Policy - IC Policy contains a mechanism set up to help investors control and contribute in the decision-making process and ensure that a conscious investment decision is made in accordance with the investment objective. Further, the policy must contain clauses such as composition, manner of conduct of meetings, decision taking, conflict resolution etc. which ensures the smooth working of fund. It is always important to check that the Investment Manager has a comprehensive and robust IC Policy in place. Additionally, it would be beneficial for investors to seek a position or seat on the IC to be able to voice concerns in relation to the investment decisions undertaken.

Seek a Waiver form any Compensatory Amount - When investors intend to contribute post initial

closing in AIF then they are normally subject to certain additional charges for the costs such as operational and organizational expenses borne by the initial investors which will be considered an addition to that of the contribution commitment made by the investor. This amount is termed as a compensatory amount which usually is in the range of 8 % to 12 % per annum. The investors, subject to their bargaining power and quantum of investment, should always negotiate for the waiver of the compensatory amount charged by the investment managers. Further, the best practice would be to have an independent value the assets for arriving at such compensatory amounts.

Avoid any 'Unreasonable' Consequences of Default - The investors must understand the process of drawdown and the consequences of default in contribution from commercial perspective. A reasonable drawdown notice period should be one of the pre-requisite considering a simple default in same may at times lead to heavy consequences like termination of investor's right to receive distribution proceeds, prohibition from further participation in the decisions related to the Fund, etc. Further, utmost care should be taken to not accept any additional liability or mandatory obligation to contribute in case of any such default by other contributors.

Key Person Event: A Key Check! - Key Person Event is primarily an event(s) which leads to departure of a "key person(s)" from the Investment Manager and thereby leading to suspension of the AIF activities for the time being. It would not be wrong to say that, the presence of well drafted and exhaustive 'key person event' clause it is one of the key checks to be made by the investors. This includes from the basic step to identify the key person in the organizations, categorizing the events which will or may lead to their departure, and determining the consequences of the same on the Fund and investment activities. It is necessary to ensure that the occurrence of events like fraud, misconduct, moral turpitude, cessation to devote substantial devotion time to the fund activities are included within the triggering events. Further, the key person event must be linked to the exit/ termination of the fund which in turn provides the investor with an option to exit the fund.

Ensure your Most Favored Nation (MFN) Status! - Lastly, but certainly the most important check is to ensure your MFN status vis-à-vis existing and prospective investors in the AIF. Taking an inspiration from the usage of such 'MFN clauses' in internal treaties, it has become a common practice to incorporate such a right in the investment documents also. MFN status ensures that the investor gets the best possible rights and positions as offered to any other existing investor or may be offered in future to new investors. In case the more favorable rights or better rights granted to any other investor, the MFN status ensures that the same should be provided to the holder as well. It is necessary for investors to be careful and seek for an MFN clause which protects their rights if not better rights at least of pari passu rights against the other investors.

In this regard, it should be noted that it is a common exercise that side letters are often entered into by the Funds and these letter with specific investors bestows additional privileges. Whereas as times such side letters are necessary for honoring the confidentiality requirements, concerns begin to arise when some investors are offered additional terms under such letters which provide them with material advantages which may result in loss or disadvantage to other holders of the same class of interest. Therefore, it becomes indispensable to conduct due diligence on the terms and conditions made available to the other investors (including their contribution agreement and side letters, if any) to assess the economic risks, controls and mitigates based on the terms indicated. Further, the investors can make it mandatory for the fund to adopt a strict and uniform policy on the applicability of side letters and the requisite disclosures ion the same.

ARA LAW View

We note that with the sharp increase in investors through the AIF route it is necessary for them to conduct a proper due diligence on the AIF before investing in AIFs and the above are some of the significant issues to be aware of while assessing the risks associated with your investment via the AIF route. Also, the above identified aspects can also be some of the terms the investors would like to incorporate to protect their interest in the fund.

EXTERNALIZATION, AN INCREASING TREND: LEGAL ASPECTS?

Advantages

One of the major triggers of externalization has been the uncertainty in the current Indian tax regime that has been bought about by ambiguities pertaining to the application of general anti-avoidance rules as well as moves such as the government's attempts to apply retrospective taxation on indirect transfers of Indian assets. Further, the high rates of corporate tax, dividend distribution tax, taxation on transfer of shares and minimum alternate tax under the Indian tax laws have added impetus to companies seeking to externalize from the standpoint of mitigating tax risks.

The above factors are compounded by the scepticism with which investors view India's current foreign exchange laws, which allow limited exit options to foreign investors. In particular, the perceived prohibition on enforcing 'put options' and pricing-related restrictions add to the risk exposure of investors. Also, with the recent advent of the Companies Act 2013, risks from increased director liability, statutory minimum pricing norms (other than under the Foreign Exchange Management Act 1999), etc., are sought to be mitigated by companies flipping overseas. Further, the relatively slow and long winding process of enforcing contractual rights in India is viewed as a deterrent for investing in Indian domiciled entities. Even though mechanisms are available for alternative dispute resolution in India, they are not necessarily viewed as efficient and effective modes for timely resolution of disputes.

In addition to the above, externalization offers a wider base of potential investors and greater access to global capital markets, thereby making fund-raising easier and more convenient, leading to better realization of business potential and higher valuations. Further, investment in offshore holding companies provides investors with immunity from the risks involved with exposure to currency fluctuations and erosion of investment value due to the depreciating Indian rupee.

Challenges

Even with externalization, India's fast changing exchange control regulations and tax laws may still bring companies externalized overseas under their ambit. The introduction of the principle of 'place of effective management' under the Finance Act 2015, whereby Section 6(3) of the Income Tax Act was altered to indicate that a company will be considered as 'tax resident' in India if its place of effective management, at any time in that year, is in India, may have the effect of offshore entities falling within the Indian tax net. Consequently, with a series of clarifications and amendments, CBDT has now clarified that a foreign entity will come under the purview of Indian tax laws, if it satisfies the POEM guidelines.

Externalization is the strategy of incorporating holding companies in offshore jurisdictions for tax optimization and operational stability.

With India's growth story gaining significant traction in the international marketplace, the prospect of Indian entities setting up offshore holding companies, especially in the e-commerce sector, has become increasingly alluring considering challenges associated with India's complex tax and regulatory regimes. The allure is further augmented by the ease of operating from more business-friendly jurisdictions and the possibility of attracting financing overseas.

Further, mirroring ownership of Indian entities in the overseas holding companies presents added challenges considering the requirement of regulatory approvals for transfer or swap of shares for non-cash consideration. Additionally, any acquisition of shares of Indian domiciled entities by overseas holding companies would require structuring from the tax and pricing/exchange control perspective. Also, the transfer of securities involved in the corporate inversion may be construed as an 'indirect transfer' and might attract potential tax liability under the Income Tax Act 1961. However, AE is determined by management, control and capital ownership. Promoters to incorporate/acquire Holdco with funds lying in offshore accounts only. In regard to source of funds, it is mandatory that the promoters should only acquire the funds lying offshore account of Holdco only. Pertinently, IPR issues with regard to ownership and logistics explicitly employee transfer,

platform ownership, procurement, software upgrade etc need to be worked out critically.

Which is a Favourable Jurisdiction?

Choice of jurisdiction for the holding organization to be resolved in light of the GAAR with effect from April 1st, 2017 that may neglect the holding organization structure in the event that it is lacking business substance. Additionally, set out below is a summarised comparative analysis, inter alia on major characteristics, of various popular off shore jurisdiction for the purpose of externalising the structure. Basis which Mauritius sand Singapore still appears to be comparatively favourable destinations even post recent DTAA amendment.

	Mautitious	Singapore	USA
Tax	Corporate Income Tax @ 17%.	Corporate Tax @ 15%.	Corporate Income Tax @ 8.7%.
	Capital gains not taxable.	Capital gains not taxable.	Capital gains taxable as corporate income tax.
	Dividend distribution not taxable.	Dividend distribution not taxable.	Dividend distribution not taxable.
	GST on e-commerce chargeable @ 7%.		
Listing	Minimum consolidated pre-tax profit requirement of $30 million.	Requirement to publish/ file consolidated audited accounts for the past 3 years, independently audited in accordance with International Standards on Accounting and reported by auditors without qualification.	Requirement to meet the following distribution standards:
	Min. issue price of securities $0.50 each.	Minimum aggregate value of equity shares to be listed MRU 20 million.	Shareholders: 400 round lot
	Requirement of at least 2 non-executive independent directors on the Board.		
	Requirement of minimum tangible assets amounting to MRU 25 million.	Market value of publicly held shares: 1.1 mm	
	Requirement to settle all debts owing to the group by its directors, substantial shareholders and companies controlled by directors/ substantial shareholders.		Minimum share price: $100 mm
Accounting	Singapore Financial Reporting Standards issued by Accounting Standards Council, Singapore	International Financial Reporting Standards issued by International Accounting Standards Board	US GAAP
IP Protection	Strong	Average	Good

ARA LAW View

The government has of late focused on bringing about "ease of doing business" in India. Towards this, it has proposed steps such as reduction of corporate tax from the current 30 % to 25 % over four years and amendment of the Arbitration and Conciliation Act 1996, in order to restrain high tax rates and counter slow enforcement of contractual rights. To attract more foreign funding, it has taken steps to ease investment norms in the online retail sector. The government has also allowed offshore listing of Indian companies without the requirement of listing on domestic stock exchanges. Although conditions attached to such listing, such as the ability to list only 51 % of shares and repatriation of funds if not utilized overseas within 15 days, may curtail such listings.

Despite these initiatives, more needs to be done to streamline the legal and regulatory framework in India and the government will need to take continuing and successive steps, and not actions in isolation, towards creating a level playing field from the perspective of taxation, regulatory, corporate and other factors. It will also have to streamline the approval process for investments and reduce barriers to exit by foreign investors in order to arrest the trend of externalization and flight abroad of Indian companies.

INDEMNIFICATION ISSUES IN PRIVATE EQUITY EXITS

The Vodafone Case

The genesis of the uncertainty around the treatment of withholding tax involved the acquisition by Vodafone Netherlands of CGP Investments Holdings Ltd (CGP)., a company registered in the Cayman Islands and controlled by the Hutchison Group for a consideration of USD $11 billion. As part of this overseas acquisition Vodafone also acquired Hutchison Essar Limited (HEL), a subsidiary of CGP in India. Under Indian tax laws, liability to withhold tax is upon the purchaser and default of such obligation makes such payer a defaulter and consequently liable for the principal sum, interest and penalties. As Vodafone Netherlands did not withhold tax on the sale consideration paid to CGP, Indian tax authorities alleged that the acquisition of HEL via CGP (the Cayman entity) by Vodafone Netherlands was structured as such to avoid tax. Indian tax authorities contended that in substance, the acquisition (of CGP) pertained to Indian assets represented in HEL, and accordingly raised assessments demanding withholding tax to the tune of USD 2.1 billion, representing capital gains made by the seller.

In dealing with this matter, the Bombay High Court largely upheld the tax department's demand and observed that though the isolated sale of CGP shares is not taxable in India, the transaction has to be given a purposive intent. It further held that the transferred assets also represented 'rights and entitlement' (by way of use of the Hutch brand, non-compete agreement, loan obligations, option for acquiring additional 15 % interest in HEL, etc.) and not the isolated sale of CGP's shares.

On appeal the Supreme Court observed the following questions:

a) Whether the sale of one share of the Cayman Islands-based organization CGP was, essentially, sale of basic assets and business interests in an Indian working organization VEL?

b) Does India have the jurisdiction to tax income/ surplus emerging or arising from sale of assets not situated in India?

> The period from 2006 to 2011 witnessed a significant inflow of private equity investment into India, making it the second most favoured investment destination after China. However, the subsequent decline in capital markets had led to a shift in exits from public offerings to other exit routes such as third-party sales which are beset with its own set of challenges, especially in light of the uncertainty around treatment of withholding tax brought about by the Vodafone case. There were several exit related deals that hit a dead end during this period after long drawn negotiations due to differences between parties in arriving at the manner of dealing with withholding tax and related mitigating factors

c) Can the arrangements of Section 195 apply to a non-resident payer of income or do they apply just to domestic tax payers?

d) Was the unpredictable complex holding structure utilized by the Vodafone bunch simply an instrument to dodge taxes in India?

e) Can the corporate veil be lifted to look through a specific exchange/transaction?

f) Is substance over form importance in such cases or form over substance?

g) Would this be an instance of tax avoidance through tax planning and hence, it met all requirements to be struck down as illegal in light of the Supreme Court's well-known decision on account of McDowell (rendered at some point in 1985)?

The Supreme Court concluded that the transfer of shares in CGP did not result in the transfer of a capital asset situated in India, and gains from such transfer could not be subject to taxation in India. Although the Supreme Court's decision came as a relief to private equity and financial investors, this case has led to a change in the

manner in which indemnities, in particular with respect to tax, in exits are dealt with.

However, post this judgement the Government has introduced General Anti Avoidance Rules which are in force from April 1st, 2017 which aims to target tax avoidance arrangements or structures. shields for keeping away from extended case. Also, various amendments have been pronounced in Income Tax Act 1961 (with retrospective effect) in line with Bombay High Court decision in above case and inconsistent with Supreme Court's view.

After Effects on Exits

With the amendments in Income Tax Act and introduction of GAAR, the effect of Supreme Court verdict in Vodafone case has been diluted, thereby giving rise to various the exit related contingencies that investors have to deal with, as was demonstrated in the Vodafone matter, it is paramount that adequate risk mitigators be negotiated with care and adopted in PE exits. Some of the points for consideration include:

Tax withholding by Purchasers, which has emerged as one of the key points of discussion

considering the tendency of tax authorities to challenge treaty benefits in the absence of 'real substance' of companies situated in favourable tax jurisdictions. Also, the judiciary's interpretation of existing taxation laws differently in matters such as the Vodafone case, Azadi Bachao Andolan case (where the Supreme Court validated the benefits of the Treaty for residents of Mauritius, subject to there being a valid tax residency certificate issue by the Mauritian Government), and the Aditya Birla Group case (in which the Bombay High Court dismissed the writ petitions filed by Aditya Birla Nuvo Limited, New Cingular Wireless Services Inc., in relation to transfer of shares of an Indian joint venture company, Idea Cellular Ltd. (ICL) and also the transfer of shares of a Mauritian company which held shares in ICL and expressed its prima facie view that such sale of shares is liable for capital gains tax in India) has given credence to this approach.

Tax indemnities by exiting investors, where earlier the norm was to specifically exclude PE investors from the requirement of providing warranties or indemnities (other than with respect to authority, due execution and the title of securities being transferred) to acquirers in an exit sale. Pursuant to the Vodafone case and the proposed introduction of the general anti-avoidance rules, many PE investors are not completely averse to also providing tax indemnities to buyers during their exit. However, on November 7th, 2017 the Central Board of Direct Taxes has issued a clarification that providing that in cases where the income of which has been subject to tax in India in the hands of a foreign investor on account of redemption or buy-back of shares of Indian entity, the provisions of section 9(1)(i) of the Income Tax Act read with Explanation 5 thereof shall not apply to the up-stream investors to avoid multiple taxation of the same transaction.

Further, the Finance Act 2017 has brought a limited relief by way of non-application of indirect transfer provisions to investors registered under Category I and II of Foreign Portfolio Investors (FPI). The Private Equity funds which are registered under the FPI regulations will be exempted from the application of provisions of indirect transfers; thereby the requirements of indemnity would not apply making the exits of private equity funds less cumbersome.

Escrow mechanisms, as an alternative to providing indemnities in favor of the purchaser to block applicable tax amounts till clarity on the tax related position or authorities issuing final clearances.

Clawback provisions, in situations where an existing PE investor is not in a position to provide tax indemnities that survive up to the entire period of limitation (typically being 7 years) due to expiry of its fund life, indemnities may be sought from the General Partners (GPs) of such investor for remainder of such period.

Exploring alternative routes, such as obtaining advance rulings from tax authorities or obtaining nil withholding tax certificates from tax authorities.

ARA LAW View

Whereas the Supreme Court's verdict in Vodafone case was a huge step by Indian apex judicial forum to gain confidence of foreign investors, however with the follow-up amendments and introduction of new laws, the situation has gone back to status quo with uncertainty

in tax treatment to commercially viable structures. This would be more so in light of the recent amendments to the Indo-Mauritian Tax Treaty (introducing levy of capital gains tax on investment in shares through Mauritius), the Singapore DTAA and other popular DTAAs.

Accordingly, investors need to take mitigating steps while negotiating their exit deals. Negotiation of indemnities in PE exits is beset with a number of legal, regulatory and operational issues which become even more critical when exiting investors have had substantial operational involvement in investee companies. However, with the effect of amendments in tax laws and introduction of GAAR, it would be interesting to see the manner in which tax indemnities are structured and evolve going forward.

[*SPACE FOR NOTES*]

POLICY AND REGULATORY WISHLIST FOR 2018

POLICY & REGULATORY WISHLIST FOR 2018

Assured Returns and Restriction on Put Options

The RBI Circular dated January 9th, 2014 prescribed that equity shares, fully and mandatorily convertible preference shares and debentures containing an optionality clause can be issued as eligible instruments to foreign investors subject to certain conditions including restrictions on 'an exit at assured return'. However, the Delhi High Court case of *Cruz City Mauritius Holdings v. Unitech Limited* decided on April this year, upheld the enforcement of foreign arbitral award in India notwithstanding the issues of contravention of FEMA restrictions, inter alia, pertaining to enforceability of put option and exit at assured returns being raised as defenses against such enforcement, moreover stating that the RBI restrictions on exit at an assured return is not a blanket restriction and basis the nature of the transaction, provision on assured return may be considered as permissible by the judiciary.

Recommendation: *Although the judgment is in line with the growing trends of investments, and it opens the window for justifying such provisions, however, a clarification in the form of a formal notification from the RBI or amendment of the FEMA provisions is required to formalize and regularize the position taken by the Delhi High Court.*

Dire need for labor reforms

Even after labor reforms were introduced in October 2014, the extant labor laws still require revamping, in order to have a regulatory mechanism in place that will not be biased against the employer or the employee. and are not restrictive. Prior approval of the Government and mandatory compensatory remuneration is required to layoff, retrench and for closure of industrial establishments and as per Section 9A of the Industrial Disputes Act 1947, 21 days' notice is required to be given to a worker, for any change in the conditions of service and under Section 25 K of the Industrial Disputes Act 1947, prior consent is required from the Government to shut down a plant that employs more than 100 workers which discourages employers to employ beyond the said limit.

A number of PE & VC investors are wary in investing in the manufacturing sector, as any introduction of new technology or revamping of the business would entail the retrenchment of certain workers.

However, inspiration can be drawn by the amendments made by the Maharashtra Government earlier this year, wherein changes to the state's Contract Labor (Regulation and Abolition) Act 1970, the Factories Act 1948 and the Industrial Dispute Act 1947 relaxed its applicability to smaller establishments and also introduced self-certification for compliances under 16 labor laws.

Recommendations: *A regulatory system that is unfairly balanced towards the promoters of an investee is not something that encourages investments. In order to attract PE & VC investors that are used to global standards of labor laws an overhaul of the central labor laws will be required, as has been carried out in states like Maharashtra and Rajasthan. A balance will have to be maintained, that improves productivity and protects the employers, but which also prevents workers' exploitation.*

Standard Operating Procedures in FDI applications: Approval timelines

The FIPB was abolished along with the single-window clearance facility it provided. Approvals for FDI will now be routed through the Foreign Investment Facilitation Portal ("FI Portal") under the Standard Operating Procedure for Processing of FDI Proposals ("SOP"), through which the DIPP will identify and forward applications to the concerned Administrative Ministry/Department ("Competent Authority") that will scrutinize the applications for approvals. Although, the SOP has set forth prescribed time limits within which Competent Authorities are required to provide comments on the applications, we also note that these time-limits are not binding and are not associated to any sanctions, if not adhered and where Competent Authorities do not revert within the time-limit, it is presumed that the they have no comments on the application.

Recommendation: *Not having a binding timeline for receipt of comment on the FDI approvals is worrisome. Clearer timelines applicable to regulatory bodies are required, that are binding in nature. Further, as the DIPP can only be consulted on a need basis only, regulatory authorities will be required to establish FDI approval departments, that are equipped to handle applications with the necessary expertise on FDI. Regulatory authorities can standardize the type of documents required for FDI applications on their websites to shorten the application period.*

BITCOIN: and Beyond

In our previous Wishlist we had stated that several financial institutions, investment funds, and financial infrastructure bodies have taken notice of the potential impact of blockchain technology on clearing and settlement and entities. However, blockchain faces practical challenges such as: (i) cyber security; (ii) privacy; and (iii) uncertain regulatory status. On February 1st, 2017, the RBI had issued a press release wherein it warned the general public against the use of virtual currencies, including Bitcoins and later even issued a statement that transactions done with Bitcoins may be termed as money laundering and that it has given no legal sanctity to such transactions. However, the RBI issued the Payment and Settlement Systems in India: Vision 2018 on June 2016, wherein it stated that regulations to keep pace with the developments in technology impacting the payment space, the global level developments in technology such as distributed ledgers and blockchain are required to be monitored, and a regulatory framework needs to be established, exhibiting an interest in the mechanism of blockchains.

Recommendation: *We are at the end of the year 2017 and we still lack substantial and effective laws regulating blockchains. Even with the warnings by the RBI and terming Bitcoins as illegal, there are already payment apps in the market that provide services for purchasing and selling of Bitcoins in the Indian market. Investors have showing interest and are currently transacting in Bitcoins in the country, therefore a curb in its popularity is highly unlikely, hence a regulatory framework is therefore the need of the hour.*

Relax Long Term Capital Gains tax norms on sale of unlisted equities by investors

As per the current Indian tax regime, there is no long-term capital gains tax on sale of listed equities, however, the PE & VC investors have to factor an additional expense of 10 % (overseas investor) and 20 % (domestic investor) as long-term capital gains tax on the sale of unlisted securities – over 24 months. Unfortunately, the position on this remained status quo this year as well. In jurisdictions such as Singapore, no capital gains tax is levied on transfer of securities. The amendment to the India – Mauritius DTAA has given India an opportunity to build up a favorable platform for the businesses especially the start-ups by eliminating the long-term capital gains tax or by reducing the same to a bare minimum of 5 %!

Recommendation: *Although the amendment is welcomed, however, the preferred change in this position would be to either treat the sale of unlisted securities as they treat listed securities provided they are held for over 24 months or have the bare minimum tax treatment across the board.*

Clarification on long-term capital gains and listed transactions

An amendment to Section 10(38) of the Income Tax Act 1961 made in June this year has created a possibility that sale of certain listed securities may not be able to avail the tax exemption on Long-Term Capital Gains ("LTGC"). Transactions involving acquisition of existing listed shares through a preferential issue, wherein the shares of the company are not frequently traded, acquisition of listed securities not through the stock exchange and acquisition of shares of a company during the period in which it is delisted, before re-listing may not be able to avail the tax exemption on LTGC. Although, the change may not affect foreign investors, including FPIs and foreign venture capital funds, however, transactions relating to preferential issue and option agreements with domestic PE & VC investors may be affected with the exemption being lifted in terms of domestic investors.

Recommendation: *Although the intention of the amendment is clear regarding genuine transactions, however, excessively stringent norms adopted by Governmental authorities may hinder investor interest and transactional structures and stakeholders have addressed their concern regarding the clarity of the notification, as the amendment does not clarify the position regarding private arrangements entered into market prices, which is a popular option exercised by PE & VC investors*

Clarification on applicability of GST on slump sale and other similar deals

In M & A transactions, 'Slump Sales' are considered to be one of the most preferred ways of carrying out a deal due to various tax and stamp duty incentives associated with it. Under the erstwhile tax regime, transfer of a business as a going concern including transfer of whole unit or a business division was not subject to Sales Tax or Value Added Tax ("VAT"). The rationale behind this was that the sale of whole business cannot be equated to sale of moveable goods which was subject to sales tax only. The Central Goods and Services Tax Act 2017 ("CGST Act") does not clearly stipulate the law vis-à-vis transfer of business as a going concern or slump sale.

Recommendations: *There is no settled position or clarity whether the transactions involving slump sales would be taxable under the new CGST Act or not. The market players are also divided in their views on the same. Considering the budding stage of implementation of this regime, unlike VAT, there is no judicial pronouncement on the issue. Therefore, the provisions of the CGST Act need to be analyzed in order to reach a fairly inferable view on the applicability of GST on Sump Sales. Also considering ours is a "Dual GST" structure, it will be pertinent to wait and watch if the state GST laws come out with any express or implied exemption (or charging!) of GST on slump sales or manner of availing input tax benefits.*

GST: applicability and implementation to be simplified to achieve and promote" Ease of Doing Business in India" in true sense!

In April 2017, it was reported that foreign investors had pumped in USD 3.5 billion in to the Indian capital market by investing majorly in debt markets through the FPI route. Market analysts stated that the reason for this boom was investor confidence in the GST in terms of transparency and tax compliance which also improved India' standing in the World Bank's index of ease of doing business. However, it is pertinent to note that the compliances and procedural complexities in relation to GST in all likelihood may overshadow the underneath objective of the newly introduced tax regime. For instance, businesses across the country are legally obligated to fill GST forms that even tax officials find difficult to complete.

Recommendations: *If the implementation of the GST is not regularized and made user friendly, the hard-earned investor confidence brought in by GST will be diluted, if establishments face difficulties complying with the GST procedural norms and end up failing to pay taxes, which in turn will jeopardize investments. In order to achieve the intended objective of the GST, it is a need of the hour that the exemption cap for GST applicability should ideally be expanded and the procedural complexities be simplified to remove the "burdensome affect" of the same.*

Fast Track Commercial Courts – Essential tool for Contract Enforceability

In January this year, the DIPP had requested that the law ministry introduce an ordinance to open fast-track commercial courts in Delhi and Mumbai, for adjudication of specialized high value matters, in order to improve the ease of doing business standards for enforcement of contracts. With high courts having exclusive jurisdiction to hear commercial matters in metropolitans such as Delhi, Mumbai, Kolkata and Chennai, the need for a faster adjudication process for the above-mentioned matters has become the need of the day, for improving the countries judicial process. India ranks at a disappointing 164 in the World Bank's index for enforcement of contracts. However, it ranks at number 4 for protecting minority investor's interests. From the World Bank's index, it is clear that the system to protect investor's investments is in place, however, enforcing their contracts may be problematic. PE & VC investors negotiate heavily on investment contracts entered into between them and the investee, however, with the current dilemma regarding enforcement of contracts, larger investments may be hindered.

Recommendation: *To compete with global standards in enforcing contracts, we will need to remove archaic restrictions on establishing commercial courts in former presidency towns. For the successful implementation of the same the State bodies also need to ensure adequate infrastructure, judicial remuneration, manpower and technology is in place for the quick disposal of cases, with minimum adjournments and facilities for electronic filings of court documents and summons. The gap between implementation and accruing benefits needs to be bridged.*

Arbitral Reforms – How to mend India's reputation as "arbitration unfriendly"

In July this year, a high-level committee submitted a report to the Government on the arbitral institutional mechanism, it reported that the failure of Government agencies to encourage institutional arbitration, delayed proceedings, lack of credible arbitral institutions and awards, judicial intervention and preference over ad hoc arbitration along with misconceptions about institutional arbitration being more expensive, were the major causes for India's poor reputation as an arbitration center. Established arbitral institutions such as the Singapore International Arbitration Centre and the London Court of International Arbitration are preferred over arbitration centers in India due to their organized structure of proceedings, fixed fee structure, expert panel of arbitrators, modern rules and excellent administrative and superior infrastructure support.

Recommendation: *There is a dire need for better infrastructure, facilities, competent pool of arbitrators with technical expertise (both Indian and foreign) probably in the form of senior counsels, law firm partners and judicial officers that understand cross-border disputes and the supervisory jurisdiction of courts. Bold steps such as the creation of the Mumbai Centre for International Arbitration and the proposal to establish the Indian Arbitration Council that is proposed to be the flagship institution to conduct international and domestic arbitration are welcome changes. However, presently greater awareness about institutional arbitration, increase in usage, adopting international best practices, greater involvement of and bar associations, to foster the preference for institutional arbitration in India is the immediate need of the hour. Further, as noted by the aforesaid report, the Government is the largest litigator in the country, to encourage institutional arbitration, steps can be taken to make it mandatory for all Government related litigation to adopt the institutional arbitration route.*

Due Diligence Framework and Insolvency and Bankruptcy Code

By a press notification in November 2017, the Insolvency and Bankruptcy Board ("IBBI") intimated that it has strengthened the Due Diligence Framework ("DD Framework") under the Insolvency and Bankruptcy Code 2016 ("IBC Code"). The revised DD Framework will be more stringent in terms of antecedents, credit worthiness and the credibility of the applicant of an insolvency resolution process under the IBC Code ("Resolution Applicant"), *including its promoters*. Even before approving a Resolution Plan, a Resolution Professional will have to ensure that the requirements under the DD Framework are fulfilled, which will not only look into aspects covering criminal proceedings, categorization as a willful defaulter under the RBI guidelines, convictions and sanctions imposed by SEBI, but will also entail a detailed report relating to the Resolution Applicant's and its promoter's past transactions which may be deemed to be termed as "preferential transactions", "undervalued transactions", "exorbitant credit transactions" and "fraudulent transactions" the findings of which will be submitted to a Committee of Creditors. Preferential transactions completed with a creditor that puts a creditor in a beneficial position or transactions that appear to be undervalued or transaction wherein the company has received exorbitant financial or operational debt through a credit transaction can all be set aside and be declared void by and Adjudicating Authority. Private companies and its promoters enter into transactions with investors that may give it the colour of the above-mentioned transactions. There is a danger that exit rights such as put or call options or even certain right of first offer rights given by promoters to investors may be termed as preferential transactions. Moreover, any arrangement between promoters of a private company and its investors to aid in the exit of the investors, may be termed as undervalued or exorbitant credit transactions (especially in terms of debt securities).

Recommendations: *PE & VC investors expect high standards of corporate governance from investees. Non-compliance by the investee may later have an effect on resolution processes and the investor's liquidation preference. The IBBI has not released the amended DD Framework, however, therefore we are yet to see how it will impact stakeholders however, if developments regarding start-ups like Stayzilla are to be taken into account wherein the promoter took the brunt of the insolvency proceeding and had criminal charges levied we can only hope that the revised framework does not have any adverse impact.*

Clarification on the scope of "Operation Creditors" and rights of "Unsecured Creditors" under Insolvency and Bankruptcy Code (IBC).

The Chennai bench of the National Company Law Tribunal ("NCLT") in one of the disputes approved insolvency proceedings against a company wherein the insolvency petition was filed by one of the vendors claiming a default of non-payment due fee amount. Interestingly, NCLT categorized the petitioner as "operational creditor" and accepted the petition for winding up of the company.

Hitherto, the unsecured creditors did not have any right to initiate insolvency proceedings under the Companies Act 2013 and generally, were kept at the bottom of the distribution bag preceded by the secured creditors, employees and Government. It is notable that the unsecured creditors still find their place in the bottom of the distribution waterfall provided only under the IBC. However, the IBC has expressly permitted an unsecured creditor now to file a winding-up petition in a civil court against a company which has not cleared dues amounting to INR 1 lakh or more and the same has been coupled with a timebound resolution mechanism as a catalyst to achieve the purpose. Certainly, the de *minimis* threshold under the IBC is much higher INR 500/- stipulated under the Companies Act 2013 and thereby gives a right to vendors only if the defaulting amount is considerably high. However, whether the new threshold is high enough to restrain the frivolous and avoidable petitions is still a question to be looked upon!

Further, there is no distinction or separate privilege given to start ups against the said provision. Accordingly, it is believed by the majority of start-up players that the extended provision under the IBC is biased against the companies and specifically against the start-ups for whom on the one hand, various development plans and incentives are being formalized by the Government and on the other such over-reaching provisions impose a constant threat of being trapped in insolvency actions.

Recommendation: *Certainly, the new code is a progressive legislation to curb out the deficiency in the previous regime. While the underlying motive of this new provision is to protect the vendors and unsecured creditors from the troubles and losses suffered in case of fall of a company, it is undeniable that the extended rights to vendors under IBC has all potential of being a victim of "abuse of law" by the overflow of frivolous applications. Although the code attempts to strike a balance by continue to rest the final power with the majority of "financial creditors", only time and "judicious" application of the same by the tribunal shall decide its fate! In order to avoid any ambiguity, necessary clarification on the scope of "operational creditors" and the suitable exemptions to start ups should be provided for.*

Allow tax pass through of losses for AIF

As per the extant tax norms relating to Alternate Investment Funds ("AIF"), if in any year there is a loss at the fund level, either current loss or loss, which remains to be set off, such loss is not permitted to be passed through to the investors but carried over at fund level to be set off against income of the next year.

Recommendation: *Investors of the AIFs should be the end recipients and beneficiaries of such benefits, an amendment in the current position to permit tax pass through of losses of the AIF to the investors would be a welcome change.*

Requirement of framework to permit unlisted REITs

Unlike Indian Real Estate Investment Trusts ("REITs"), US REITs are not required to list their shares on a public exchange, and hence can elect REIT status without its shares having to trade on a public exchange. The so-called unlisted (or non-traded) REIT sector has witnessed tremendous growth.

Recommendation: *For the growth and success of REITs, it would be beneficial to allow Indian REITs to either be listed or unlisted as against making it mandatorily listed.*

Allow 100 % investments under the Foreign Portfolio Investments Route for Start-ups

Under the FDI Policy 2017 and the recently amended Foreign Exchange Management (Transfer or Issue of Security by Persons Resident Outside India) Regulations 2017, issued on November 7th, 2017, the Government have now permits 100 % FDI under the automatic route, by Foreign Venture Capital Investors ("FVCI") in start- ups, irrespective of the sector.

Recommendation: *For the sector to attract even more traction, we recommend that it would be beneficial to allow the other Foreign Direct Investment players to be allowed 100% investments under FDI automatic route.*

Rationalization of applicability of General anti avoidance Rules (GAAR)

Under the GAAR, income tax authorities will now be vested with wide powers to declare transactions as impermissible avoidance agreement if they consider the transaction as being entered solely to obtain a tax benefit and if it either creates A right or obligation not considered at arm's length or lacks commercial substance, or the transaction is not carried out for bonafide purpose. It allows revenue authorities to disregard, merge or re-characterize any step in any such arrangement, or re-characterize equity in to debt and vice versa. The demarcation between "tax evasion" and "tax avoidance" has been completely done away with and the "permissible tax avoidance transactions" are also impermissible now under GAAR.

Recommendation: *Objectivity and transparency is required in the GAAR mechanism. Wide discretion given to the tax department should either be curtailed down or proper checks should be imposed. Clarifications by the tax department on what would constitute a transaction, which are not for bona fide purposes, will be welcomed, as the provision leaves lot of scope for subjective application of law. If required, grandfathering period should be increased for the existing structures and investments.*

Necessary amendments in SARFAESI Act and Income Tax Act to facilitate the allowance of 100 % FDI under the automatic route in Asset Reconstruction Companies

In furtherance of its objective of tackling rising non-performing assets of banks, the DIPP had brought about significant changes to the FDI policy relating to Asset Reconstruction Companies ("ARCs") allowing 100 % FDI under the automatic route in ARCs to encourage much needed foreign capital to deal with stressed and non-performing assets enabling ARCs struggling for funds, to purchase of bad loans from banks

Recommendation: *Although a great move on the part of the Government, however, concurrent amendments in the SARFAESI Act will have to be made to reflect the changes pertaining to permissible shareholding of sponsors in ARCs since under the SARFAESI Act, prior approval of the RBI is still required for any substantial change in the management or for any change in sponsorship, hence negating the purpose of permitting 100 % FDI in the sector.*

Relaxation of Priority Funding Norms

The relaxation of approval norms for FDI in Asset Reconstruction Companies ("ARC") was a great move by the Government to improve the dire state of Non-Performing Assets ("NPA") in the country. However, the business models of ARCs are unable to attract foreign investors, unless certain regulatory norms are relaxed. Indian ARCs are looking to the RBI to permit priority funding of bad loans as a measure to infuse much needed capital to revive stressed assets. ARCs are also seeking regulatory amendments to attract priority funding into ARCs as well. Extant guidelines do not permit ARCs to fund any NPA which is not in their portfolio and banks are hesitant to fund already cash strapped NPAs, therefore such funding needs can be fulfilled by private sector investors looking for viable investment opportunities in NPAs or even directly in ARCs.

A number of PE & VC investors have shown interest in investing in ARCs, however, the current NPA revival laws do not permit an investor to take over the control and management of the NPA, since a revived unit is to be returned to the original management. ARCs are only permitted to convert the debt quotient into equity in the NPA after a period of 3-5 years which too long a period.

Recommendation: *In order to bring the relaxations of FDI norms in line with the regulatory framework, the Government must review the regulatory restrictions imposed on ARCs in order to boost investor confidence.*

Allow tax pass through of losses for AIF

As per Section 115 UB of the Income Tax Act 1961 relating to Alternate Investment Funds ("AIF"), if in any year there is a loss on investment, such losses shall be allowed to be carried forward and it shall be set-off by the investment fund. Due to which the investors would be taxed an amount greater than the "real" taxable income, making AIF's unattractive

Recommendation: *Investors of the AIFs should be the end recipients and beneficiaries of such benefits, an amendment in the current position to permit tax pass through of actual losses of the AIF under Section 115 UB of the Income Tax Act 1961 to the investors would be a welcome change.*

Requirement of framework to permit unlisted REITs

Unlike Indian Real Estate Investment Trusts ("REITs"), US REITs are not required to list their shares on a public exchange, and hence can elect REIT status without its shares having to trade on a public exchange. The so-called unlisted (or non-traded) REIT sector has witnessed tremendous growth.

Recommendation: *For the growth and success of REITs, it would be beneficial to allow Indian REITs to either be listed or unlisted as against making it mandatorily listed.Iquem patquem usuamquo tantra con dium in ina, sum pari publium ublices soludeffrem moveribus nonsum, vivis ciemus, escitiactus int? Ectordi ussulvis haec viditemod mo pratuus ultore, st? Rurox multudam. M. Marte comnem iam oc, untrit, nos, nes ma, que tantem.*

[*SPACE FOR NOTES*]

PE & VC CONCLAVE 2017

PE & VC CONCLAVE 2017

ARA LAW was proud to host the PE & VC Conclave at the Taj West End, Bengaluru last year - an event aimed to provide a platform to investors and business owners for sharing their experiences in doing business in India and their expectations for the year 2017. The conference consisted of enlightening panel discussions - moderated by Mr. Rajesh Begur and Gunderson Dettmer - on the PE & VC trends in India, the opportunities and challenges to the start-up sector in India, and whether exits are as easy as entries in the Indian PE & VC landscape. The sessions involved thought provoking discussions over various subjects of relevance to the PE & VC environment of the country. We had the benefit of panelists sharing their valuable industry inputs, as well the participation of an enthusiastic audience.

We are pleased to share a few pictures from the event with the reader!


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