Investing in Start-ups in India

Shardul Amarchand Mangaldas

For Private Circulation only | December 2019

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Background

This note provides a succinct analysis of the law in undertaking equity financing by incubation facilities or investing entities ("**Investing Entity**") for investing in early-stage companies in India. The analysis below is equally applicable for, and relevant to, setting up investment vehicles in India, for investments in larger companies, but the relevant monetary thresholds below will need to be kept in mind.

The analysis is separated into two stages of raising capital by the entity planning to undertake the investments: (a) investment of its own funds through the Investing Entity ("**Phase 1**"); and (b) raising money through the Investing Entity from other investors and investing such pooled capital through the Investing Entity ("**Phase 2**").

The analysis will broadly cover the following:

- the corporate entity (a company or a limited liability partnership ("**LLP**") or a trust) which is best suited for undertaking Phase 1 and Phase 2 activities; and
- sector specific registrations, if any, which are needed by the Investing Entity for undertaking Phase 1 and Phase 2 activities.

Applicable Laws

- Companies Act, 2013 ("**Companies Act**");
- Limited Liability Partnership Act, 2008 ("**LLP Act**");
- Reserve Bank of India Act, 1934 ("**RBI Act**");
- Master Direction on Exemptions from the provisions of the RBI Act, 1934 (updated as on 11 November 2019) ("**Exemption Notification**");
- Master Direction on Core Investment Companies (Reserve Bank) Directions, 2016 ("**CIC Regulations**");
- Securities and Exchange Board of India (Alternative Investment Funds) Regulations, 2012 ("**AIF Regulations**");
- Master Direction on Non-Banking Financial Company – Non-Systemically Important Non-Deposit Taking Company (Reserve Bank) Directions, 2016 ("**NBFC Regulations**");
- Foreign Exchange Management (Debt Instruments) Regulations, 2019;
- Foreign Exchange Management (Non-debt Instruments) Rules, 2019; and
- Foreign Exchange Management (Mode of Payment and Reporting of Non-Debt Instruments) Regulations, 2019.

Analysis

The Investing Entity may undertake Phase 1 and Phase 2 activities in the manner set out below.

Phase 1

For undertaking Phase 1 activities, the Investing Entity will either qualify as a core investment company ("**CIC**") or a non-banking financial company ("**NBFC**"). Accordingly, the Phase 1 activity of the Investing Entity shall be governed by either the CIC Regulations or the NBFC Regulations, as may be applicable, depending on whether the Investing Entity meets the financial thresholds stipulated by the Reserve Bank of India ("**RBI**") in this regard under the relevant regulations.

Incorporating the Investing Entity

Under Section 45-IA of the RBI Act, the RBI has been given the authority to grant a certificate of registration to a *"non-banking financial company"* (i.e., a *"financial institution"* which is a *"company"*). Section 45-I (c) of the RBI Act defines a *"financial institution"* as a non-banking institution which carries on the business of, *inter alia*, (a) financing by way of making loans or advances or otherwise; or (b) acquisition of shares, stocks, bonds, debentures or other marketable securities. It follows that, in relation to the activities of a *"financial institution"*, the RBI can only register and regulate *"companies"*.

The proposed activity of the Investing Entity in Phase 1 will qualify as an activity of a *"financial institution"*. Pursuant to Section 45-IA of the RBI Act, no *"non-banking financial company"* can commence or carry on the business of a non-banking financial institution without, *inter alia*, obtaining a certificate of registration from the RBI. Since the RBI can only issue such a certificate of registration to a *"company"*, an LLP or a trust which is undertaking the activity of a *"financial institution"* cannot be registered with, and regulated by, the RBI. No exception exists in this regard for an LLP.

Any application made to the Registrar of Companies ("**ROC**") for incorporating an LLP needs to specify the business for which the LLP is being incorporated. If the application states that the proposed LLP will be undertaking investment/financial sector activities, then the ROC will refer the application for a "no-objection" from the relevant financial sector regulator. In case the application specifies that the proposed LLP will undertake the business of investing in other entities, such applications are referred to the RBI for its "no-objection", basis an administrative arrangement between the ROC and the RBI. In practice, we understand that the RBI does not give the "no-objection" for incorporating LLPs for carrying on the business of investing in the shares of other companies or any other NBFC activities.

Therefore, in order to undertake Phase 1 activities, the Investing Entity will need to be incorporated as a *"company"* under the Companies Act, preferably as a private company, which can avail the exemptions available to a private company under the Companies Act.

Registration under the CIC Regulations

The Investing Entity may qualify as a CIC and become subject to the CIC Regulations, if the Investing Entity satisfies the following tests:

- it holds not less than *__90% of its net assets__* in the form of investment in equity shares, preference shares, bonds, debentures, debt or loans in *__group companies__*;
- its investments in the equity shares (including instruments compulsorily convertible into equity shares within a period not exceeding 10 years from the date of issue) in *__group companies__* constitutes not less than *__60% of its net assets__* as mentioned above;
- it does not trade in its investments in shares, bonds, debentures, debt or loans in group companies except through block sale for the purpose of dilution or disinvestment; and
- it does not carry on any other financial activity referred to in Section 45-I(c) and 45-I(f) of the RBI Act, except investment in bank deposits, money market instruments, government securities, loans to and investments in debt issuances of group companies or guarantees issued on behalf of group companies (collectively, "**CIC Test**").

The CIC Test is applied in terms of *"net assets"* of the investment company, which is defined under the CIC Regulations as meaning total assets excluding: (a) cash and bank balances; (b) investment in money market instruments and money market mutual funds; (c) advance payments of taxes; and (d) deferred tax payment. In addition, for the purposes of the CIC Test, the investments need to be in *"group companies"*. A CIC cannot invest in partnerships, LLPs or any association of persons similar to a partnership. Its investments need to be in *"companies"*. The term *"companies in a group"* is defined under the CIC Regulations to mean an arrangement involving 2 or more entities related to each other through any of the following relationships as defined under the relevant accounting standards: (a) subsidiary-parent;

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(b) joint venture; (c) associates; (d) promoter-promotee for listed companies; (e) a related party; (f) parties with common brand names; and (g) investments in equity shares of 20% and above.

In addition to the CIC Test, if the Investing Entity also meets the following tests, it will qualify as a systemically important CIC ("**SI-CIC**"):

- its total assets are not less than INR 1 Billion (approx. USD 14.01 Million); and
- it raises or holds public funds (collectively, "**SI-CIC Test**").

If the Investing Entity does not meet the additional SI-CIC Test, it will only be a non-systemically important CIC ("**Non-SI CIC**"). A Non-SI CIC is subject to only those provisions under the CIC Regulations, which are applicable solely to CICs that are not systemically important (such requirements will include reporting requirements, etc.). A Non-SI CIC is exempt from obtaining any RBI registration pursuant to the Exemption Notification read with the CIC Regulations.

In light of the above, it follows that: (a) if and when the Investing Entity qualifies or is about to qualify as a SI-CIC, it will need to obtain an RBI registration under the CIC Regulations; or (b) if the Investing Entity qualifies only as a Non-SI CIC, it need not obtain any RBI registration. However, a Non-SI-CIC will need to comply with those provisions of the CIC Regulations, which are applicable solely to CICs that are not systemically important.

Registration under the NBFC Regulations

The Investing Entity may qualify as an NBFC and become subject to the NBFC Regulations, if the Investing Entity satisfies the 'principal business' test as laid down in the RBI's press release dated 8 April 1999. This press release provides that a company will be treated as an NBFC if:

- such company's financial assets are more than 50% of its total assets (netted off by intangible assets) ("**Asset Test**"); and
- its income from financial assets is more than 50% of its gross income ("**Income Test**").

Both the Asset Test and the Income Test need to be satisfied simultaneously for the company to be viewed as being engaged in financial services/activities as its 'principal business' and, therefore, needing an NBFC registration. If the Investing Entity meets the Asset Test and the Income Test basis the last audited balance sheet of the Investing Entity, then it will need to obtain a certificate of registration from the RBI under Section 45-IA as an NBFC and comply with the NBFC Regulations.

In addition to the Asset Test and the Income Test, if the Investing Entity also has total assets of INR 5 Billion (approx. USD 70.07 Million); and above, then it will qualify as a systemically important NBFC and will need to comply with the regulations applicable to a systemically important non-deposit taking NBFCs, in addition to maintaining/obtaining its certificate of registration from the RBI under Section 45-IA.

As and when the Investing Entity meets or is about to meet the SI-CIC Test or the Asset Test/Income Test, it will need to obtain a certificate of registration under Section 45-IA from the RBI. Accordingly, at the time of commencing its operations, the Investing Entity will need to determine whether it needs to obtain an RBI registration.

Prior to commencing its business, if the Investing Entity foresees meeting the SI-CIC Test as soon as it makes it first downstream investment, it should apply for and obtain a registration under the CIC Regulations before making such investment. If Investing Entity does not meet the SI-CIC Test at the time of commencing its operations, then during the course of its operations, the Investing Entity will need to periodically check if and when it is meeting or is about to meet the SI-CIC Test or the Asset Test/Income Test. If and when the Investing Entity is meeting, or is about to meet, the SI-CIC Test or the Asset Test/Income Test, it needs to apply for and obtain the relevant registration from the RBI.

Phase 2

For undertaking Phase 2 activities, the Investing Entity will need to either: (a) obtain a Category-I Alternative Investment Fund ("**AIF**") registration from SEBI and adhere to the stipulations applicable to a "venture capital fund" under the AIF Regulations; or (b) obtain an "angel fund" registration from SEBI and adhere to the stipulations applicable to an "angel fund" under the AIF Regulations.

Category-I AIF Registration
Regulation 3 of the AIF Regulations make it mandatory for an entity or a person to register with SEBI for acting as an AIF.

A Category-I AIF is a type of entity, which privately pools funds from investors for investing in, *inter alia*, unlisted securities of start-ups or early stage ventures or in socially or economically desirable areas. In contrast, if the Investing Entity decides to invest as a private equity investor or a debt investor or it undertakes leverage to invest, then the Investing Entity will need to obtain a Category-II or Category-III AIF registration, as applicable.

Investment in an AIF is subject to certain stipulations under Chapter III of the AIF Regulations, which, *inter alia*, include:

- each AIF needs to have a minimum corpus of INR 200 Million (approx. USD 2.80 Million);
- each investor in an AIF needs to invest a minimum of INR 10 Million (approx. USD 140,000);
- the manager, sponsor, promoter or designated partner, as applicable, of an AIF needs to have a continuing investment in the AIF of not less than 2.5% of the corpus or INR 50 Million (approx. USD 700,000), whichever is lower;
- an AIF cannot have more than 1,000 investors; and
- it cannot raise money through public issue and can only pool funds through private placement.

Angel Fund Registration
Regulation 19A(1) of the AIF Regulations defines an "angel fund" as a category of a venture capital fund that raises funds from "angel investors" and invests in accordance with the applicable provisions of the AIF Regulations.

Investment in an *"angel fund"* is subject to certain stipulations under Chapter III-A of the AIF Regulations, which, *inter alia*, include:

- angel funds shall only raise funds by way of issue of units to angel investors;
- an angel fund needs to have a corpus of at least INR 50 Million (approx. USD 700,000);
- the maximum period up to which an angel fund can receive investment is five years;
- the minimum investment from an angel investor needs to be INR 2.5 Million (approx. USD 35,000), and such investment shall not exceed INR 100 Million (approx. USD 1.40 Million);
- an angel fund cannot raise money through public issue and can only pool funds through private placement;
- an angel fund shall invest in start-ups with turnover of less than INR 250 Million (approx. USD 3.50 Million), which start-ups are not promoted by an industrial group and do not have family connections with the angel investors;
- angel funds shall not invest in associates; and
- investment by an angel fund shall be locked-in for period of one year.

Setting up the Investing Entity
For undertaking Phase 2 activities, the Investing Entity may be set up as a trust or be incorporated as an LLP or a company under the Companies Act. Most AIFs formed in India are set up as private trusts under the Indian Trusts Act, 1881 because such trusts are subject to least amount of compliances and provide the trustee and the settlor maximum latitude to determine the terms of the private trust deed and run the trust in accordance thereto. Since the term of AIF funds is finite, they need to be inevitably wound up. Relative to a company or an LLP, a private trust is subject to least amount of regulations and compliances relating to its winding up. A trust may either be managed by trustee(s) or its management is outsourced to an investment manager (which may be a natural person, company or an LLP) pursuant to an investment management agreement. Investment management companies are believed to have the expertise and the resources to manage such pooling and investment vehicles.

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In contrast, only a few AIFs in India are incorporated as LLPs. LLPs are governed by an LLP agreement which needs to be amended every time a new investor invests in the LLP. Investors in an LLP are designated as 'partners' and the person responsible for managing such an LLP and undertaking all its compliances is called a 'designated partner'. Relative to a private trust and an LLP, a company is subject to most amount of compliances for raising money through private placement. In view of the above, in order to undertake Phase 2 activities, the Investing Entity should be set up as a private trust for pooling funds, which should preferably be managed by a company under the Companies Act or an LLP pursuant to an investment management agreement.

Potential sectors in Indian Start-up Ecosystem

- **Health Tech:** In the last couple of years, a growing number of health tech start-ups have come up to bridge the gap the currently exists between healthcare providers and patients, across urban, semi-urban and rural areas.
- **Logistics:** In recent years, an army of tech-enabled start-ups has emerged in the country, thereby bringing innovation and disruption into the mainstream. Looking back, logistics start-ups started gaining a foothold in India only after the onset of the e-commerce industry. As players like Flipkart, Snapdeal, Amazon turned to establishing their in-house logistics services, a number of start-ups started tapping other areas to support the existing supply chain solutions or to fill the gaps in the otherwise fragmented and un-organized logistics industry.
- **Fin-tech:** Considered as the year of financial services, 2017 saw the emergence of a legion of promising fin tech start-ups that are working to bring innovation and disruption to the otherwise conservative Indian banking sector.
- **Travel Tech:** Currently ranking 7th globally in terms of its contribution to the country's GDP, the Indian tourism and travel sector underwent an impressive 8.5% jump last year, with 2017 witnessing an additional 6.7% leap. Interestingly, domestic travel is what currently leads the charge, accounting for a staggering 88% of the total revenue generated by the tourism sector in 2016.
- **Education Tech:** By wielding up-and-coming technologies, Indian education tech start-ups are working to enhance access to affordable quality education across primary, secondary and higher levels. In 2017, the country's education market underwent substantial growth, with many start-ups expanding into tier II and tier III cities in order to create a social impact. Instead of focusing on the academic curriculum, a number of start-ups are now working to provide personality development and career counselling services. Players in the education tech space of the Indian start-up ecosystem include BYJU'S, Unacademy, UCLID, Avagmah, Embibe, iProf, Simplilearn, Meritnation, Toppr, NeoStencil and Englishleap.
- **Enterprise Tech:** Enterprise tech, as a sector, is moving forward in India with businesses getting more specialised help from SaaS and ERP management start-ups. With technological advancements in India, numerous SMEs are now leveraging SaaS and related technologies to optimise their overall performance. In 2017, the major contribution in the enterprise software sector was made by SaaS (software-as-a-service) start-ups. At the top of the SaaS game are two giants, Zoho and Freshworks, with over 4,000 total employees and a combined revenue of over $350 million.
- **Consumer Service:** Consumer services, as in hyperlocal food and grocery delivery, has been the hottest ticket in the Indian start-up ecosystem since 2015. However, it saw a dramatic fall in 2016, as funding dropped almost overnight and more than 100 start-ups shut their shops. However, 2017 was more generous to consumer services start-ups in the country. Two of the most promising sub-sectors this year were food delivery and only grocery. On the one hand, foodtech unicorn Zomato became profitable throughout the 24 countries where it operates, and across all its businesses. On the other, big players like Amazon, Flipkart and Paytm are now

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taking their first steps into the country's online grocery delivery and food retail market.

- **Deep Tech:** Artificial intelligence and Big Data were quite possibly the most talked about sectors in the Indian start-up ecosystem this year. Be it in ecommerce, fin-tech, banking, surveillance, customer service and support or analytics, or from intelligent shopping assistants to helpful conversational bots, deep tech is finding wider usage in our daily lives and will continue to do so. AI has emerged as a promising technology that can help to deliver services across different segments efficiently and effectively, to a higher number of consumers at a very low cost. Big Data is the foundation of AI, since it enables AI to come up with predictive and prescriptive analysis.
- **Cyber Security:** With Digital India as the dominant theme in the country, given the many vulnerabilities of the digital world, cybersecurity has emerged as a key focus area. Analytics and IoT will find greater use in online fraud detection and to detect cyber-attacks in real time. Internet-of-things will further provide tighter security at hardware installations such as ATMs, payment devices, etc.by providing real time protection. Start-ups in this space can expect to gain a lot from the spike in demand of such services.
- **Continuity in growth of SaaS (Software-as-a-service):** SaaS is one of the major areas of interest for investors, as can be seen from over 60 start-ups operating in the vertical SaaS domain receiving funding in 2016, comprising 50% of the overall SaaS funding during the year. The VC investments are projected to increase with domestic SaaS firms establishing global presence. Experts are optimistic about emergence of a billion-dollar SaaS company from India, in the coming years.

Government Policies

The government plays an important role for establishing the new enterprises. The plans, policies, initiatives, strategies of the government affect the entrepreneurs. Following are the 19 plans as an initiative for start-ups:

- **Self-certification**: The main objective of the government is to reduce the load on the start-ups hence allowing them to concentrate fully on their business and keeping the low cost of adherence. It will include labour laws and environment related laws.
- **Start-up India hub:** A single contact point will be created for the start-ups in India, which will enable them to exchange knowledge and access to funds.
- **Register through app:** An online portal, will be available in the form of a mobile application, which will help entrepreneurs to interact with the government and other regulatory officials.
- **Patent protection:** A monitoring system for patent inspection at reduced costs is being created by the central government. It will enhance perception and acquisition of the Intellectual Property Rights (IPRs) by the entrepreneurs
- **INR 100 Billion (approx. USD 1.40 Billion) fund:** The government will develop a pool with a starting aggregation of INR 25 Billion (approx. USD 350 Million); and a total aggregation of INR 100 Billion (approx. USD 1.40 Billion) over four years, to help new entrepreneurs. The important role will be played by the Life Insurance Corporation of India in blossoming this collection. The fund will be managed by a group of professionals selected from the start-up industry.
- **National Credit Guarantee Trust Company:** A National Credit Guarantee Trust Company(NCGTC) will be created with a budget of INR 5 Billion (approx. USD 70.07 Million) per year for the next four years to help the drift of funds to entrepreneurs
- **No Capital Gains Tax:** Investments through venture capital funds are exempted from the Capital Gains Tax. The same policy will be executed on start-ups.
- **No Income Tax for three years**: Start-ups would not pay Income Tax for the first three years.
- **Tax exemption for investments of higher value**: In case of ventures of higher amount than the market price, they will be exempted from paying tax.
- **Building entrepreneurs:** Creative study plans for students will be implemented in over 500,000 schools. Apart from this,

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there will also be an annual businessman grand provocation to develop high class businessmen.

- **Atal Innovation Mission:** This Mission will be propelled to revitalize ideas and motivate creative youngsters.
- **Setting up incubators:** A private-public partnership model is being considered for 35 new incubators and 31 innovation centres at national institutes.
- **Research parks:** The government plans to lay seven innovative research parks, including six in the Indian Institute of Technology campuses and one in the Indian Institute of Science campus.
- **Entrepreneurship in biotechnology:** The government plans to construct five advanced biotech nests, 50 advanced bio incubators, 150 technology transplant offices and 20 bio connect offices in the country.
- **Dedicated programs in schools:** The government plans to inculcate transformational programs for scholars in over 500,000 schools.
- **Legal reinforces:** A committee of moderators will give legal help and reinforcement in complying patent applications and other papers.
- **Rebate:** An exemption value of 80% of the total value will be given to the startups on filing the patent applications.
- **Easy rules:** Standards of communal acquisition and mandate of switching have been easier for the entrepreneurs.
- **Faster exit:** If an entrepreneur is unsuccessful than the government will help him to get a particular resolution for their complication

Conclusion

In order to undertake Phase 1 activities, the Investing Entity will:

- need to obtain a prior government approval under the foreign exchange law(s);
- need to be incorporated as a *"company"* under the Companies Act, preferably as a private company;
- either qualify as a CIC or an NBFC.

At the time of commencing its Phase 1 activities or during the course of its operations, if and when the Investing Entity qualifies or is about to qualify as a SI-CIC, it will need to obtain an RBI registration under the CIC Regulations; or (b) if the Investing Entity qualifies only as a Non-SI CIC, it need not obtain any RBI registration. However, a Non-SI-CIC needs to comply with those provisions of the CIC Regulations, which are applicable solely to CICs that are not systemically important.

During the course of the operations of the Investing Entity undertaking Phase 1 activities, basis its last audited balance sheet, if the Investing Entity meets or is about to meet the Asset Test/Income Test, it will need to obtain a certificate of registration under Section 45-IA from the RBI and comply with the regulations applicable to non-deposit taking systemically important or non-systemically important NBFCs, as applicable.

In order to undertake Phase 2 activities, the Investing Entity:

- will need to register with SEBI as a Category-I AIF or an *"angel fund"* and comply with the applicable provisions of the AIF Regulations; and
- should be set up as a private trust, although it may be set up as a company or an LLP under the AIF Regulations.

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Please feel free to address any further questions or request for advice to:

Mr. Rudra Kumar Pandey
Partner
Email: rudra.pandey@AMSShardul.com
M +91 9871792734

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