SEBI AMENDS NORMS FOR INVESTMENTS BY ANGEL FUNDS AND FPIS; IMPOSES RESTRICTIONS ON COMPENSATION AGREEMENTS

Introduction

On November 23, 2016, the Securities and Exchange Board of India (the "**SEBI**") approved several important changes to Indian securities regulations, including, an amendment to the SEBI (Alternative Investment Fund) Regulations, 2012 (the "**AIF Regulations**") to ease the requirements for investment in start-ups by angel funds, an amendment to the SEBI (Foreign Portfolio Investor) Regulations, 2014 to allow foreign portfolio investors ("**FPIs**") to invest in unlisted non-convertible debentures and securitized debt instruments and an amendment to the SEBI (Listing Obligations and Disclosure Requirements) Regulations, 2015 (the "**Listing Regulations**") to regulate compensation agreements between promoters, directors and key managerial personnel of listed companies and investors. This update discusses the implications of the foregoing changes.

Investment in start-ups by angel funds

The AIF Regulations govern privately pooled investment vehicles in India, and angel funds are registered as Category I Alternative Investment Funds under the AIF Regulations. Angel funds registered under the AIF Regulations have to comply with certain investment restrictions specified in the AIF Regulations. However, these restrictions created fetters on investment. In an attempt to remedy this, the SEBI has approved the following changes to the AIF Regulations:

- Under the Startup India Action Plan, an Indian company can be considered as a start-up up to the completion of five (5) years following its incorporation and provided it is recognized by the Inter-Ministerial Board of Certification established under the Startup India Action Plan. As such, the shorter qualification threshold of three (3) years post-incorporation has been done away, and investments of angel funds in companies that are five (5) years of age (post-incorporation) will qualify as start-up investments. Although well meaning, imposing such timelines is redundant. Often times, start-ups (especially product start-ups) need much longer to develop products and need angel investors to stay by their side for longer periods of time. Having an angel fund's investment de-categorized as an investment in a start-up simply because the start-up has been incorporated for more than five (5) years does not appear to be the right approach.

- The cap on the maximum number of angel investors in a registered fund has been increased from 49 to 200. This is because the Companies Act, 2013 permits private companies to have up to 200 shareholders, instead of 49 shareholders as was the case under the Companies Act, 1956. This will increase the ability of angel fund to approach and get a larger pool of investors and have a greater corpus, which will enhance its ability to make more and/or follow-on investments.

- An angel fund can now invest INR2,500,000 (Indian Rupees Two Million Five Hundred Thousand) in a start-up, instead of INR5,000,000 (Indian Rupees Five Million) as was required earlier. Many start-ups require a lower amount of capital and are often not willing to give a higher equity stake. Therefore, the reduction in minimum investment amount will help such companies raise funds at the initial stage of idea development without diluting too much.

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- The lock-in period for an investment made by an angel fund in a start-up has been reduced from three (3) years to one (1) year. The previously mandated period was counterproductive as many companies that seek angel investment need further funding within one (1) to two (2) years. However, the onerous lock-in period meant that the company had to either deal with a clutter of investors or was denied alternative funding altogether. Moreover, the reduction in lock-in period will also allow the angel investors to exit earlier and invest in other start-ups.

- Angel funds have been allowed to invest up to 25% of their corpus in overseas venture capital undertakings. This change places angel funds, who invest at the highest risk level, at par with other alternative funds. Importantly, this will allow such funds to spread or diversify their risk over different geographies and economies so as to fortify themselves against a fall in their Indian investments.

FPIs can invest in unlisted debt securities and securitized debt instruments

The SEBI has permitted FPIs to invest in unlisted non-convertible debentures or bonds issued by any Indian company and in securitized debt instruments. Previously, FPIs were permitted to invest in listed or to be listed non-convertible debentures and in unlisted non-convertible debentures issued by infrastructure companies. Further, FPIs were not permitted to invest in securitized debt instruments.

Investment in unlisted non-convertible debentures or bonds will be subject to the minimum residual maturity of at least three (3) years, and the end use restrictions preventing investment in real estate business, capital markets and the purchase of land will apply. However, the minimum maturity period requirement will not be applicable to investments in securitized debt instruments.

This change follows the SEBI's decision in September 2016 to allow FPIs to directly trade in corporate bonds without going through any broker or intermediary. Moreover, the Reserve Bank of India has also recently relaxed its rules for such investments by FPIs. With this, the SEBI aims to deepen India's capital markets by developing the corporate bond and debenture segments and increasing the flow of investment into the economy. Moreover, the change permits investments in private companies, many of whom prefer issuing debt securities so as to avoid giving up their equity in the business.

Restrictions on compensation agreements

The SEBI has approved changes in the Listing Regulations making it mandatory for promoters, directors, key managerial personnel or any other employee of a listed company proposing to enter into any profit sharing or compensation agreement with an investors such as a private equity fund to obtain prior approval from the SEBI and from the public shareholders of the listed company. Further, any such agreements entered into in the past three (3) years, including agreements which are no longer valid, are required to be notified to the stock exchanges. Furthermore, in upcoming shareholders' meetings, an approval by simple majority of the public shareholders must be taken for subsisting agreements which have been executed prior to the date of notification of the amendment to the Listing Regulations, and interested persons must not vote on such matter(s).

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Earlier this year, the SEBI issued a consultation paper and invited comments from the public on the issue of promoters, directors and key managerial personnel of listed companies entering into compensation agreements without the knowledge of the shareholders of the listed company. More recently, the SEBI has issued notices to a listed company seeking information about the incentive agreements entered into between the promoters and a private equity investor. The main concern behind imposing an approval requirement for such compensation agreements seems to be to ensure full disclosure to the shareholders, because such arrangements result in indirect remuneration being received by the promoters, directors and key managerial personnel of the listed company, and such persons may be guided by their compensation agreements rather than their fiduciary obligations to act in the best interests of the listed company. In our view, this change is overreaching. A robust, performance-based compensation agreement to a CEO or a promoter of a company will ensure that the CEO or promoter tries to enhance the business or the valuation of the company, which will, in turn, benefit the public shareholders.

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