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CHALLENGES TO PRIVATE EQUITY INVESTMENTS IN THE CORPORATE REGULATORY FRAMEWORK OF INDIA

ABSTRACT [1]

The Indian economy post 1991 reforms heavily relied on Private Equity (PE) investments for boosting capital growth. There is a rising demand for PE investments in India as it is recovering economically moving towards pre-Covid levels. Private Equity firms primarily focus on acquiring private companies that are not listed via equity investments and revamp its structure before selling it off at a higher return. Private equity vastly makes use of debt to fund its acquisitions enabling them to generate high return on equity. The regulatory framework governing PE funds have undergone remarkable changes over the past few decades. However, the current state of affairs is unfavourable for PE investments owing to stringent regulations in the corporate regime. Due to regulatory hindrances PE firms rely on a customised model as against the traditional private equity investment model followed by western countries. The existing legislations dealing with PE are unreasonable, cosmetic and excessively prescriptive that are detrimental to the smooth functioning of PE investments. The Companies Act, 2013 contains certain provisions pertaining to private placement, compulsory convertible debentures, leverage buyout and director's liability that are adverse to PE investments. Furthermore, the SEBI Regulations, particularly the regulations governing Alternative Investment Funds have few criteria that makes the process of PE investment cumbersome such as valuation of portfolio companies even during early-stage investment. The recent amendments incorporated by SEBI on AIF regulations did not deviate from the earlier legislation in a way that is beneficial to the PE regime. Moreover, there are issues concerning the exit strategies that draw potential investors away from PE.

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I. INTRODUCTION

The economic and commercial milieu of India is heavily dependent on investment, often categorized as fundraising. Funds are directed to an organization through different channels such as private equity, venture capital, angel broking, etc. The prevailing laws of the country regulate the procedure and extent of such investments. In this regard, private equity essentially refers to the money invested in private companies that are not traded publicly. Such investment aims to restructure the private entity and sell it off at a higher return on investment. However, the corporate laws in the current regime pose certain challenges in the smooth functioning of private equity transactions, specifically in relation to capital structuring and distribution of profits. The main issues and challenges affecting the private equity regime arise from tax and lack of regulatory flexibility, inaccurate valuation, and hostile competitive conditions for sealing good-quality deals. Additionally, India is also facing the issue of exit overhang, and the burden to exit is expected to rise.[2]

Over the past two decades, private equity transactions have played a significant role in India's capital formation. This is due to globalization which grabbed worldwide attention on the Indian economy. There are various reasons behind such an increase in demand for private equity investments. Firstly, due to India's entrepreneurial status, enhanced transparency and proper regulation, and thirdly due to a growing economic structure.[3] There various laws, policies, and regulations designed and enacted by the Government which apply to a private equity fund during its formation or in the course of a private equity transaction.[4] Furthermore, both the company in which the fund is invested and the firm which invests are mandated to abide by the legislations formulated in this regard. It is essential to note that the traditional private equity investment model has worked out in developed economies; however, private equity firms rely on a customized model in India due to several regulatory hindrances.[5]

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[2] Asma Chandani, *Private Equity Investment in India: Trends And Challenges* (2015) (June 20, 2021), https://www.law360.com/articles/674977/private-equity-investment-in-india-trends-and-challenges.

[3] Shankar & Chellaswamy, *Private equity investment in India: Investors'outlook and problems with reference to Tamilnadu* (2018) (June 22, 2021), http://shodhganga.inflibnet.ac.in:8080/jspui/handle/10603/303702.

[4] Apurv Sardeshmkh, *Private Equity in India: The Legal Perspective* (2018) (June 21, 2021), legallyindia.com/private-equity-unleashed/private-equity-in-india-the-legal-perspective-20180327-9205.

[5] Afsharipour, Afra. *Corporate Governance And The Indian Private Equity Model*, 27 National Law School of India Review, 17, 17-40 (2015).

II. REGULATORY FRAMEWORK VIS-À-VIS PRIVATE EQUITY INVESTMENT

The aspects of private equity transactions in India are regulated through various legislations such as the Companies Act, 2013, regulations formulated by the Securities and Exchange Board of India (SEBI), and the Income Tax Act, 1961. The private equity funds are primarily registered as Alternative Investment Funds (AIF) under the SEBI (Alternative Investment Funds) Regulations, 2012, in the form of a trust.

III. COMPANIES ACT, 2013

The Companies Act, 2013[6] majorly deals with the conditions and procedures pertaining to the transfer and issue of shares and enlisting provisions for the governance of both shareholders and the board. The Companies Act, 1956[7] did not have a tight grip on private companies as they were loosely regulated compared to public companies. However, the amended Act of 2013 obscured the distinction between private and public companies subjecting private companies to strict compliances similar to that of public companies.

Private Placement

The Indian company law regime does not permit private entities to offer their shares to the public; however, securities are offered to select individuals through private placement. Private equity is closely connected to the elements of private placement, and hence the provisions pertaining to private placement enumerated in the Companies Act apply to private equity transactions.

Issuance of securities through private placement to raise funds was reasonably straightforward in the earlier regime. As mentioned above, due to a lenient approach in the 1956 Act, the regulations concerning private placement were minimal. However, with the advent of the amended Act of 2013, the yardsticks to be met for executing a private placement became stringent.[8] For example, a lengthy record of disclosures by the company offering the securities to the potential subscribers is necessary to execute private placement along with various other information regarding corporate actions. Furthermore, a company planning to issue securities

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[6] The Companies Act , 2013, No. 18, Acts of Parliament, 2013 (India) [hereinafter Companies Act].
[7] The Companies Act, 1956, No. 1, Acts of Parliament, 1956 (India).
[8] The Companies Act 2013 § 42.

via private placement should also procure a valuation report based on which the offered securities are priced.

This has given rise to a situation of overregulation that is uncalled for in a private placement. The rationale behind such regulation is unnecessary as the stakeholders are private entities that do not involve the general public, including the retail investors. Moreover, modern Private Equity funds having expertise in the investment domain do not require extensive disclosures from the company offering their securities. The complications of private placement under the Act have encouraged private companies to tackle the issue by offering securities through the 'rights issue'[9]- wherein the existing shareholders have the right to buy more shares of the company, in proportion to the number of shares they hold now.

In this regard, certain amendments were made to the Companies Act 2013 with respect to Section 42 and Rule 14 of the Companies (Prospectus and Allotment of Securities) Rules, 2014[10] in relation to the process of private placement, whereby most of the unwanted procedural hiccups were eliminated. However, these amendments had only a few substantive changes while the majority was merely clarificatory in nature. Parallel to these amendments, which sought to remove overlapping and further disclosure specifications for prospectuses, the Ministry of Corporate Affairs (hereinafter MCA) could have resolved the conflicts and issue of overlapping existing between Rule 13 of the Share Capital Rules and Rule 14 of the Companies (Prospectus and Allotment of Securities) Rules and the SEBI regulations for preferential allotment by listed companies and the regulations concerning private placement stipulated under the Companies Act including deeming Form PAS-4 unsuitable for preferential issue by listed companies. Furthermore, the MCA could have discarded the extensive disclosure requisites under Form PAS-4 for better efficiency. Thus, for example, the requirement of 'absence of a statutory or regulatory action' initiated against a promoter in any of the preceding three years (before private placement) can be replaced with the requirement of no pending legal action.

Director's Liability

[9] The Companies Act, 2013 § 62.
[10] Abhinav Kumar & Neha Samant, *Recent Amendments to the Private Placement Guidelines – Revamp or Cosmetic?* (2018), (June 22, 2021), https://corporate.cyrilamarchandblogs.com/2018/09/recent-amendments-private-placement-guidelines-revamp-cosmetic/.

In the earlier regime, the 1956 Act did not lay stress on the fiduciary duties of the directors of a company as it was majorly based on Common law rules. However, the 2013 Act has widened the exposure to a director's liability due to numerous scandals concerning corporate governance. In this regard, a non-executive director who does not actively participate in the day-to-day activities shall be liable for any corporate misconduct. The rationale behind imposing such liability is based on the fact that even a non-executive director is deemed to have the knowledge of a company's functioning.

Expansion of director's liability is detrimental to private equity investments. As per the general norm, a seat on the Board of a portfolio company is offered in a Private Equity transaction. The issue arises when a director nominated by the Private Equity fund is exposed to stringent liability under the Companies Act. Furthermore, Private Equity funds require the portfolio companies to take insurance policies for the nominee directors and indemnify any form of liability attached to these directors. Apart from this, a PE fund may also do without a seat on the board of directors but nominate an "observer" instead to keep a watch on the functioning of the portfolio company. Insofar as the regulation is concerned, it has played an instrumental role in mitigating the risk of corporate governance scandals; however, some light is to be shed on the contours of director's liability, especially in the context of private equity.

From a broader perspective, the present current regulations concerning the liability of directors expose non-executive directors to investigations and penal proceedings for any misconduct or wrongdoing by a company irrespective of their knowledge or entanglement in the said default. In addition, loss of one's reputation, stress, and adversities caused by never-ending legal proceedings have dispirited and discouraged several PE fund nominees from accepting board positions. Moreover, the initiation of criminal proceedings against non-executive directors without any proof of their complicity has led to such directors running to various High Courts to quash criminal proceedings under Section 482.[11] As a result, the judicial system gets burdened with lengthy legal proceedings.[12]

Compulsory Convertible Debentures

[11] Code of Civil Procedure, 1908, § 482, No. 05, Acts of Parliament, 1908 (India).

[12] Bharat Vasani & Esha Himadri, *Vicarious Liability of Non-Executive Directors: A Case for Reform of Law,* (2020), (June 24, 2021), https://corporate.cyrilamarchandblogs.com/2020/11/vicarious-liability-of-non-executive-directors-a-case-for-reform-of-law/

Reading Section 73 of the Companies Act, 2013, along with Companies Acceptance Deposit Rules, 2014, it is explicit that private companies are not permitted to raise 'deposits' from the public. In this regard, issuing debentures is brought within the ambit of 'deposits' as per Section 2(31) of the Companies Act. In the previous Act of 1956, to evade such categorization under 'deposits,' the only criteria was to ensure its convertibility into equity and secure such debentures with immovable property. However, the 2013 Act strengthened the grip on the issuance of compulsorily convertible debentures, wherein the conversion was mandated to happen within five years along with ensuring that the issued debentures are secured by a first charge or a charge ranking *pari passu* with the first charge on assets on the company issuing the debentures.

The time limit placed by the Act is undesirable as it restricts the flexibility of the issuing company to utilize the funds raised optimally. As a result, a company is forced to devise a plan which aligns with the time limit enumerated in the Act. Moreover, the portfolio companies are forced to put aside a notable chunk of funds as security against these debentures, which they might not be in a position to do so. There is another take to the issue at hand wherein compulsorily convertible debentures can be issued for which the period of conversion is extended to more than five years if it is issued to any other company registered in or Outside India, a person resident outside India or director as per clause (ii), (vi) and (viii) of Rule2 (1)(c) of the deposit rules.

In view of the subtleties associated with the issuance of a CCD via private placement and the lack of clarity surrounding the provisions concerning CCD through a rights issue, there exists some amount of ambiguity leading to different interpretations. Accordingly, the Ministry of Corporate Affairs could chart out the contours of issuing a CCD, aiding the stakeholders involved in such transactions.

Leverage Buyout

PE firms have most often than not, made investments in companies through Leverage Buyout (LBO). However, owing to legal complexities and illiberal regulatory framework, the PE firms are forced to adopt strategies deploying a customized model to tackle the issue. The provisions of the Companies Act cause hindrances to traditional LBOs as companies are prohibited from leveraging their assets for purchasing the equity in the target company. Moreover, the Companies Act of both the earlier and current regime restricts public companies (including private companies that are subsidiaries of a public company) from providing financial assistance to any person to purchase or subscribe to their shares.[13][14] Hence, raising funds through LBO buy keeping their assets as collateral is disallowed, and it applies to all public companies irrespective of them being listed.

To evade this, a public company has an option to convert to a private company by delisting itself before being acquired through LBO. However, the purpose of delisting is cumbersome and complicated as they are subject to regulatory compliances and majority-shareholder approvals. The process of delisting a company is dealt with under the Securities and Exchange Board of India (Delisting of Equity Shares) Regulations, 2021[15], replacing the SEBI (Delisting of Equity Shares) Regulations, 2009. Delisting often goes unsuccessful due to various reasons.

An acquirer willing to take over a company cannot do so without going through a reverse book-building method wherein the public shareholders can agree on a price above the floor price. The final price is the price at which the acquirer can cross a 90% threshold of the share capital. In this regard, an issue arises when an inordinate premium is demanded by the shareholders putting the acquirers at a disadvantage. Despite having the option of putting forward a counteroffer, the acquirers cannot extract any benefit because once the reverse book building process is finished, several investors and traders would have accumulated positions in the stock speculating a massive increase in price. Furthermore, if the acquirer reaches the threshold of 90%, he is forced to execute the takeover even if the discovered price by the public shareholders is unreasonably high.

IV. SEBI (ALTERNATIVE INVESTMENT FUNDS) REGULATIONS, 2012

Alternative Investment Funds(hereinafter referred to as AIF) essentially refer to those funds pooled privately from sophisticated investors irrespective of their citizenship and invested in adherence to India's investment policies for the purpose of generating profits.[16] Private equity funds fall within the ambit of AIF and are defined as a fund that is principally aimed at investing

[13] The Companies Act, 1956, § 77(2), No. 1, Acts of Parliament, 1956 (India).
[14] The Companies Act, 2013 § 67(2).
[15] The SEBI (Delisting of Equity Shares) Regulations, 2021, Reg. 20(1), Gazette of India, pt. III sec. 4 (Jun. 10th, 2021) [hereinafter SEBI (Delisting of Equity Shares) Regulations, 2021].
[16] The SEBI (Alternative Investment Funds) Regulations 2012, Reg. 2(1)(b), Gazette of India, pt. III sec. 4 (May 12th, 2012) [hereinafter SEBI (Alternative Investment Funds) Regulations 2012].

in equity, equity-related instruments, or partnership interests of the investee company based on the objective of such funds.

AIFs are required to provide their investors with insights into the valuation procedure and the methods used in evaluating the assets. Category I and II AIFs which include private equity, are to undertake asset evaluation once in six months by an independent valuer appointed by the AIF. However, there is no clear-cut definition of an independent valuer in the regulation. Suppose the managers of the AIF were to consider the definition of a valuer under SEBI (Real Estate Investment Trusts and Infrastructure Investment Trusts) Regulations; in that case, the qualifications of the independent valuer should be taken into consideration.

Valuation

AIFs face various hurdles in evaluating the net asset value. Primarily, on ascertaining the fair value of assets, complications in relation to the unit of accounting may arise. Generally, the AIFs prefer clubbing both equity and debt in the schedule of investments and lay down the aggregate fair value of investments made in each portfolio company. Customarily, private equity funds report the total value of their aggregate capital invested in a portfolio company and subsequently delineate each instrument along with the allocated value. The rationale behind this approach is that stakeholders would prefer transacting in the varied sets of debt and equity as a combination of assets rather than independently. Moreover, while determining the fair value of investment made by the AIF, especially under Category II, the fund is expected to define how each section of equity would partake in future distributions from a sale or liquidity activity creating valuation issues.

Another hurdle faced in relation to valuation is during early-stage investment, wherein the investment is on the riskier side. In this case, portfolio companies do not have a back-tested business model, good infrastructure, nor do they generally have short-term goals of generating revenue, profit, cash flow from operational activities, or diversification. Therefore, the valuation of assets at this stage of investment is challenging as determining a fair value for the companies is not easy. Most often than not, PE funds opt for investment strategies roughly during the roll-up or turn-around of businesses. These are strategies aimed at the long-term, wherein the value is generated only after a period of gestation. Henceforth, it is only feasible to determine the fair value on a bi-annual or annual basis as evaluating the assets for a period of less than six months to show a tremendously changed paradigm is highly unlikely.

Furthermore, in order to estimate the value of equity, the value of debt has to be ascertained. However, in some situations, the funds may have insufficient information about the debt, making it challenging to determine equity value. Funds generally make use of par value, face value, or payoff amount as a base for measuring debt while valuing equity, and hence any change in the value of debt will cause a change in the value of equity.

The SEBI (Alternative Investment Funds) (Second Amendment) Regulations, 2021

The AIF regulations had its share of shortcomings from the beginning. There were significant issues concerning these regulations, which the SEBI dealt with through a recent amendment.[17] The issues involved ambiguity surrounding the aspects of investing in units of other AIFs and mistiness in laying down the scope of 'start-ups' while prescribing a code of conduct aimed at the personnel handling the activities concerning AIFs. In relation to the amendments made by SEBI in allowing AIFs to concurrently invest in multiple units of other AIFs and directly in the equity of the investee company, there were certain restrictions placed. The amended regulations placed a limit to the diversification of AIFs to 25% and prohibited investment in AIFs of a higher category.[18] Furthermore, an investee AIF is not permitted to invest in other AIFs hence putting a cap on their single investment.[19]

Regulations touching upon the aspects of layers of investment require revamping owing to certain loopholes in structure. For example, if an AIF X makes an investment in AIF Y, it becomes an investible fund of Y. In this regard, Y's decisions pertaining to investment and diversification will be based on the available investible funds, which also includes a portion of investment by X. Labelling and differentiating investments from the investible funds of Y at this level is problematic. In continuation, Y decides to invest in another AIF Z, which further invests in AIF A, and AIF X at the same time directly invests in the securities of AIF B. At this juncture, a question stands whether X is in violation of the regulations if the consolidated fund (indirect and direct investments) goes beyond 25% of the investible funds. Furthermore, since the limit is relevant only to investments made via AIFs, the investee company can be directed through other investment vehicles. Henceforth, unless a clear distinction is made out between

[17] The SEBI (Alternative Investment Funds) (Second Amendment) Regulations, 2021 Gazette of India, pt. III sec. 4 (May 5th, 2021) [hereinafter SEBI (Alternative Investment Funds) (Second Amendment) Regulations, 2021].
[18] The SEBI (Alternative Investment Funds) (Second Amendment) Regulations, 2021, Reg. 15(1)(c).
[19] The SEBI (Alternative Investment Funds) (Second Amendment) Regulations, 2021, Reg. 15(1)(da).

the layers of investment to ascertain the non-adherence to the regulations, the purpose of the amendment sits foggy.

V. CONCLUSION

In the present economic backdrop, the fact that private equity will contribute immensely towards raising funds is undisputed. However, notwithstanding India's devotion to formulating policies that enable 'ease of doing business,' the country has time and again tightened the regulatory grip on raising funds through private equity and venture capital. Therefore, it is pertinent that structural reforms are introduced to bridge the gap between capital seekers and providers. Moreover, PE investments are on the rise as lockdown restrictions due to the ongoing pandemic are reduced worldwide. Hence, a regulatory framework that ensures ease of doing business with flexible compliances is of prime importance.[20] However, in the current regime, various legislations governing the companies have conferred unnecessary authority on the government to intrude in the functioning of private companies, interrupting the balance between creating a lenient regulatory structure for booming companies aiming for global markets and protecting the interests of stakeholders.

SEBI has time and again strived to unwind strict compliances in relation to the PE regime. As a result, frequent amendments are made to the existing laws concerning the AIFs benefitting the stakeholders. To a great extent, SEBI has been instrumental in smoothening the contours of the existing inflexible regulatory system concerning the AIFs; however, certain issues still remain unaddressed.

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[20] Raghubir Menon, *The Private Equity Law Review: India* 10 The Law Reviews (2021), (June 25, 2021), https://thelawreviews.co.uk/title/the-private-equity-review/india-fundraising.