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CCPS are better than the Equity in an Early Stage Start-Up for Investors

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The company issued securities to the people in return for the money they invest in. Equity securities are in the form of shares and generally represent an ownership stake in the entity. Investors which hold equity securities are not liable to repayment but they have a stake in the profit of the company which is received as a dividend. An individual which holds equity shares enjoys voting rights in the company and can participate in the decision-making like voting matters regarding appointment and termination of directors. Private equity investors preferred a well-recognized investment instrument which is called Compulsorily Convertible Preference Shares.

Keywords: *equity, startup, investor.*

INTRODUCTION

The company generally issues some instruments to the general public to subscribe to so as to receive funds from them. The company issued securities to the people in return for the money they invest in. A financial tradable instrument that is bought and sold in the market such as shares, debentures, bonds, options, and warrants is known as "Security". Ownership or potential ownership or creditor ownership in a corporation is represented by "Security". The Significant aspect of Security is Transferability. For example, An individual's fixed deposit with a bank cannot be transferred to another person but the shares of the company can be transferred to another Company. In Section 2(h) of the Securities Contracts Regulations Act, 1956[1] the term Securities has been defined. When the securities are issued by the issuer to the public for the first time is a Primary Market transaction. It means the securities which are issued by a company and government securities.[2] Instruments that derive their value from already offered securities are derivatives. The combined fund is represented by the units by collective investment scheme or mutual funds invested in securities offered by companies. Securities issued by securitization companies are generally issued to financial institutions rather than the general public. Bonds that are issued by the government giving a fixed amount of return to the public are Government Securities.

EQUITY SECURITIES AND DEBT SECURITIES

Equity securities are in the form of shares and generally represent an ownership stake in the entity. Investors which hold equity securities are not liable to repayment but they have a stake in the profit of the company which is received as a dividend. It happens only when the company is being wound up and all the creditors are being paid off and the residual which is left will be returned to the equity holders.

An individual who carries debt securities does not carry any voting rights in the company and does not affect the ownership of the company. Debt securities represent the money that is borrowed by the company (the debtor) from the investor which must be repaid-with interest with stipulated terms and conditions. The investor may be secured by the assets of the company or may be unsecured.

EQUITY SHARES AND PREFERENCE SHARES

[1] Securities Contracts Regulations Act, 1956, s 2(h)
[2] *Ibid*

Equity Shares and Preference are the kinds of shares that are generally issued by the Company. There are some equity shares that are issued by a company with differential voting rights. An individual which holds equity shares enjoys voting rights in the company and can participate in the decision-making like voting matters regarding appointment and termination of directors Equity Shares with differential voting rights are not given any voting rights. These are mainly issued to financial investors which are especially interested in capital for their investment but not interested in running or having ownership in the stake of the Company. On the other Preference, Shareholders do not enjoy any voting rights except in the case when some decisions affect their own class of shares.

Investors which hold equity shares do not receive any dividend as a fixed return therefore their investment is at high risk as they do not receive any fixed return by the Company. Although if the company has a high amount of profit the shareholders will also enjoy high returns. On the other hand, investors which hold preference shares have a preferred right to repay the capital that they paid in the company over the equity shareholders.

HYBRID INSTRUMENTS

Companies that issue sometimes single security instruments have characteristics of more than one type of security. For instance, it may possess characteristics of both equity and debt instruments. The most common type of hybrid security instrument is a convertible debenture. Convertible preference shares carry the preferred right to receive a fixed return and in the future, it can be converted to equity shares if the company does well. To meet the needs of different kinds of investors these instruments are issued.

CONVERTIBLE SECURITIES

If at the option of investors or compulsorily a security instrument is converted to another security instrument in the future is called convertible securities. Generally, preference shares or debt instruments are converted into equity shares. The instruments which are converted into equity shares may be converted at a fixed price or a discount to market price. According to the needs of the business, the specific nature of the instruments is governed.

Preference Shares

As it is cleared now that preference shareholders give up the voting rights and in the event of liquidation preference is given to preference shares over equity shares. Unlike debentures, which can be secured or unsecured but in the case of preference shareholders, no security is given. Although, when the shares are to be redeemed out of profits of the Company, a sum which is equal to the number of nominal shares being redeemed shall be transferred to Capital Redemption Reserve.

Convertible Preference Shares

Convertible Preference Shares are an example of hybrid Security. These types of preference shares can be converted into equity shares according to the terms and conditions at a future date. If the shares are converted into equity shares then automatically merits related to preference shares will be lost by the shareholders and don't have the option to convert them back into preference shares. The issue of "convertible shares" by SEBI is regulated as the issue of such shares by listed companies.

Non-Convertible Preference Shares

These types of shares are not converted into equity shares. As it is cleared that Preferences Shares are repaid back as it is a perpetual instrument and it is exhausted back by the Company when the money is repaid. Issue of such shares by listed entities is regulated by Securities and Exchange Board of India (Issue and Listing of Non Convertible Redeemable Preference Shares Regulations, 2013.[3] All the issues of non convertible preference shares are governed by these regulations as SEBI ICDR is not applicable to non-convertible securities.[4]

Debentures

The debt instrument which is issued by a company that yields a fixed rate of interest for a fixed duration is called debentures. After the particular duration of a time period, it is

[3] Issue and Listing of Non-Convertible Redeemable Preference Shares Regulations 2013
[4] *Ibid*

redeemed back. The maximum redemption time period for secured debentures in India is 10 years and in case if a company is involved in infrastructure projects then the redemption time period can be extended to 30 years according to the rule 18 of Companies (Shares Capital and Debentures) Rules, 2014[5] Under Indian Law there is no bar on unsecured debentures being issued on a perpetual basis. Only in certain conditions, perpetual debentures are not redeemable.[6] **For example**: In 2011 Tata Steel carried out 1500 crore issuance of perpetual debentures. In the event of nonpayment, insolvency, winding up the holders of debentures can initiate proceedings against Tata Steel under the information memorandum.

Convertibility

As a hybrid instrument debentures can also be issued by the company wherein debentures can be converted into equity shares at a predetermined rate according to the terms and conditions of the issue. These types of debentures are called convertible debentures.

On the basis of the convertibility it is classified into the following types:

Partially Convertible Debentures: At the issuer's notice, some part of debentures may be converted into equity shares that are held by investors. At the time of issue, the ratio of conversion is determined.

Fully Convertible Debentures: At the issuer's notice, these types of debentures are converted into fully equity shares. According to the terms of the issue the rate at which debentures are converted into equity shares is governed. Once if it is converted into equity shares then the investor will enjoy all the rights related to the equity shares as other investors enjoy the company.

Optionally Convertible Debentures: These are the types of debentures that are converted into equity shares according to the choice and wish of the investors as well as the rate of conversion of the equity shares would be determined at the time of issue.

[5] Companies (Shares Capital and Debentures) Rules 2014, rule 18
[6] *Ibid*

Non Convertible Debentures: These are generally not the example of hybrid securities and they are just simple debentures. These are not converted into equity shares as they are nonconvertible. They only carry a higher rate of interest. As compared to convertible debentures.

COMPULSORILY CONVERTIBLE PREFERENCE SHARES

Private equity investors preferred a well-recognized investment instrument which is called Compulsorily Convertible Preference Shares. It is also referred to as an anti-dilution or hybrid Instrument. If the conversion remains well below twenty-five percent then NBFC can issue CCPS without availing the permission of the Reserve Bank of India. It means it is correct to say that when there is no noticeable increment in the shareholding then RBI's permission is not necessary.NBFC should take the permission of RBI if preference shares are converted into equity shares. The maximum time period to issue convertible preference shares by NBFC is 20 years. At the time of the release of the instrument, these types of shares are compulsorily converted into equity shares on predetermined conditions. The CCPS is ought to be treated as equity shares according to the RBI.

During the release of equity shares to new investors, the company's promoters take many advantages from CCPS by maintaining equity shares intake. When new investors introduce the fund at a higher valuation so the promoters can easily convert the compulsorily convertible preference shares in the event of lower valuation of shares. Private equity investors can take many benefits from CCPS. Investors generally link the performance of the company at the time of conversion. This clearly and specifically indicates when NBFC achieves the target growth then only the shares will be converted into equity shares. The Company has the right to crank the shares when the NBFC does not achieve the target growth. Any acquisition which is fifteen or above then opens the possibility of offers according to the terms and conditions of the Capital market regulator. Suppose the private equity firm directly acquires 14.9% and remaining in the securities which might transform equity within eighteen months.

STARTUPS AVAIL BENEFIT FROM CCPS

Owners of startups firms benefit from curbing CCPS stake at the stage of funding of new investors in absence of infusion of new funds. The company can handle its equity by introducing additional funds as it is also referred to as anti-dilution securities. It also helps to handle their equity shares to manage the organization by holding a good amount of stake in the company.

Regulatory framework Related to CCPS

It is not a straightforward business decision for NBFC to issue CCPS Securities. Promoter's equity stake can be curbed as it plays a significant role. Under four major laws CCPS is governed which is issued by NBFC which are as follows:

- Companies Act

CCPS are governed under the following bylaws which are issued by NBFC:

- Companies Act, 2013 - Section 42,[7] Section 62,[8] Section 55.[9]
- Companies (Prospectus and allotment of Securities), Rules 2014[10]
- Share Capital and Debentures, Rules, 2014[11]

FEMA Regulatory Framework

CCPS are also identified as equity instruments. Under any circumstances, the price during conversion should not be lower than the fair value determined during the issuing of the securities. Under foreign direct Investment Policy, Indian Companies are not eligible to issue non-convertible preference shares. It is also regulated by External Commercial Borrowings. But Indian companies are eligible to issue Compulsorily Convertible preference shares under some limitations if it is assured to overseas investors the minimum lock-in period and returns.

CONCLUSION

[7] Companies Act 2013, s 42
[8] Companies Act 2013, s 62
[9] Companies Act 2013, s 55
[10] Companies (Prospectus and allotment of Securities) Rules 2014
[11] Share Capital and Debentures Rules 2014

The debentures issued including non Convertible debentures should be secured and it should be assured by NBFC. Until the formation of security, the security cover is inadequate or not formed the issue proceeds will be routed to secure escrow accounts during the issuance period. As far as strategic decision making of the company and investors is concerned in the current scenarios Compulsorily Convertible Preference Shares plays a significant role.