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Start-up funding through SAFE Notes

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Introduction to SAFE Notes

- SAFE stands for Simple Agreement for Future Equity. SAFE notes are the type of convertible securities which are converted to Equity shares in the future based on the events mutually agreed upon in the contract.
- SAFE notes allow investors to buy shares in the future equity funding round based on the valuation decided at the time of the round.
- It gives relief to the early-stage start-up founders from lengthy process of the valuation. In the most cases, there is hardly any base to value the early-stage startup due to incomplete prototype, pending IP registration, early revenue stage (if any), unclear product-market fit, etc.
- The notes are converted compulsorily in the future based on some agreed event such as equity financing, liquidation, merger, etc.
- Indian version of the SAFE notes is generally known as iSAFE. It is legally treated at par with Compulsorily Convertible Preference Shares (CCPS).

Types of SAFE

Type of note is determined based on the negotiations around the valuation cap and the discounts:

1. **Conversion at the fixed date**: the conversation happens at a fixed future date.
2. **Valuation cap**: the minimum or maximum or both cap is agreed on the valuation. Meaning if in the future round, valuation cannot exceed or cannot go below the cap.
3. **Discount**: certain discount percentage is negotiated which is applied at the future valuation
4. **Valuation cap and Discount**: where valuation cap as well the discount is negotiated.
5. **Most Favored Notes (MFN)**: no valuation caps and no discounts. When in the subsequent round of issue of the SAFE note terms are more favorable, then in such case, initial investors can ask for the same terms.

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Benefits

- Simple 5–6-page documentation required for the deal.
- The deal takes much shorter time compared to lengthy Share Holder Agreement (SHA).
- Time and compliance cost both are saved, and founders can focus on business.
- As mentioned above, in early-stage start-ups, where valuation is very difficult, this is the most preferred method.
- No dilution of equity until the next equity financing round.

Compliances

- Companies Act

  Since iSAFE takes legal form of CCPS, compliances regrading it needs to be done:
  - Increase of authorized share capital.
  - Passing of necessary board and shareholder's resolution.
  - Issuance of shares.

- FEMA

  In case iSAFEs are **issued to foreign nationals**;
  - It needs to be reported to RBI in form FC-GPR.
  - It shall not violate the FEMA rules regarding restriction on issuance of certain securities below the market value.

Compliances

- <u>Income Tax Act</u>

- Capital gain does not arise in the event of conversion from iSAFE to equity shares.

- The provisions of section 56 (2)(viib) needs to be complied during the issue, failing which, the tax is attracted on the premium exceeding the fair market value (Start-ups recognized by DPIIT are given relaxation in this provision with certain conditions. Finance Bill 2023 has now proposed to apply the said section to Non-Resident investors also).

THANK YOU

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