CHAPTER II

VENTURE CAPITAL REGULATION IN INDIA
– AN EVALUATION

REGULATORY ISSUES

There are a number of rules and regulation for venture capital and these would broadly come under the following heads:

- The Securities and Exchange Board of India has come out with a set of guidelines.
- The Central Board of Direct Taxation (CSDT) governs the issues pertaining to income tax on the proceeds from venture capital funding activity.
- The Indian Trust Act, 1882 or the Company Act, 1956 depending on whether the fund is set up as a trust or a company. (In the US, a venture capital firm is normally set up as a limited liability partnership).
- The Foreign Investment Promotion Board (FIPB) and the Reserve Bank of India (RBI) in case of an offshore fund. These funds have to secure the permission of the FIPB while setting up in India and need a clearance from the RBI for any repatriation of income.
- In addition to the above there are a number of arms of the Government of India - Ministry of Finance that may have to be approached in certain situations. Also intervention of allied agencies like the Department of Electronics, the National Association of Software and Computers Manufactures (NASSCOM) and various taskforces and standing committees is not uncommon.

Probably this explains why most of the funds prefer to take the easy way out by listing as offshore funds operating out of tax havens like Mauritius.
(where the Avoidance of Double Taxation Treaty exists and the income may be freely repatriated).

I. ROLE OF SEBI

The Securities and Exchange Board of India Act, 1992, empowers SEBI under Section 11(2) thereof to register and regulate the working of venture capital funds. This power has been given to SEBI only recently, under the Securities Laws (Amendment) Act, 1995 with effect from 25 January 1995. SEBI has since formulated regulations for regulating venture capital companies and funds, known as Securities and Exchange Board of India (Venture Capital Funds) Regulations.

SEBI Regulations on Venture Capital Funds

SEBI (VCF) Regulations (VCFR) have come into force having been notified and published on 4 December, 1996 in Gazette of India. Extraordinary, Part-II, Section 3, Sub-section (ii). SEBI had earlier circulated a Consultative Paper No. XI as draft Regulations for Venture Capital Funds early, on 13 February, 1996 and based on suggestions received in response thereto, comprehensive regulations have been finally adopted which came into force on 4 December, 1996. The important parts of the regulations are discussed below:

a. **Prohibition on investment in financial service companies or institutions**

   Investment by venture capital funds in the equity shares of any company or institution providing financial services is prohibited. In other words, leasing and hire-purchase companies, non-banking financial companies, miscellaneous non-banking companies, housing finance companies, etc. cannot avail of the venture capital financing.
b. **Investment in unlisted companies**  At least 80 percent of the venture capital funds shall be invested in the equity shares or equity related securities issued by a company whose securities are not listed on any recognised stock exchanges. This condition promotes early stage financing.

Investment can also be made in the equity shares or equity related securities of a company whose securities are to be listed or are listed where VCF has made any investment through private placement prior to the listing of securities.

c. **Investment in financially weak or sick companies**  Within the stipulation of 80 per cent of the VCI; investment, a venture capitalist can invest in the equity share or equity related securities of the financially weak company or a sick industrial company whose securities may or may not be listed on any recognised stock exchanges. This condition supports later stage and turnaround financing by the venture capitalists.

However, to avail of the finance under the condition, the financially weak company should have accumulated losses at the end of the previous financial year which must show erosions in networth of more than 50 per cent but less than 100 per cent as at the beginning of the previous financial year.

e. **Investment in assisted companies**  Venture capitalist can finance the companies which have already been assisted in any of the categories mentioned above.

f. **Investment in listed companies**  Venture capitalist can invest the balance 20 per cent of the VCF in any listed company's securities viz. shares and debentures or make intercorporate deposit with listed companies or invest directly in R&D division of listed companies.
A venture capital fund, for the purpose of these regulations means, unless the context otherwise requires, a fund established in the form of a company or a trust which raises money through loans, donations, issue of securities or units as the case may be and proposes to make investments in accordance with these regulations. Therefore a venture capital fund may be structured either a company registered under the Companies Act, 1956 or as a trust under the Indian Trust Act 1882 registered under the Indian Registration Act, 1908.

1. Registrations of Venture Capital Funds

To enter venture capital financing activity, Government Guidelines-1988, earlier, had prescribed prior approval from the Department of Economic Affairs, Ministry of Finance.

In consonance with the same practice, SEBI-VCFR stipulates, registration of the organisation with SEBI and grant of certificate for commencement of the business of venture capital financing for all, new, as well as, existing companies or funds within the prescribed period of three months from the date of enforcement of the regulations. Applications for registration and grant of certificate are to be made on the prescribed form A along with application fee of Rs 25,000. In addition to registration fee a sum of Rs. 5,00,000 has to be paid to SEBI towards grant of certificate.

2. Eligibility criteria

For the purpose of grant of certificate by SEBI, the following conditions must be satisfied :-
A. If the application is made by a company

1. The main object of the company as per its Memorandum of Association must be the carrying on of the activity of venture capital fund.

2. It is prohibited by its Memorandum and Articles of Association from making an invitation to the public to subscribe to its securities.

3. None of its directors or its principal officer or employee is involved in any litigation concerned with the securities market which may have an adverse bearing on the business of the applicant. The directors or the principal officer or employee must not have been at anytime convicted for an offense involving moral turpitude or any economic offense and is a fit and proper person to act as director or principal officer or employee of the company.

B. If the application is made by a trust

The instrument of trust (Trust Deed) is in the form of a deed and has been duly registered under the provisions of the Indian Registration Act, 1908

1. The main object of the trust is to carry on the activity of a venture capital fund

2. None of its trustees or directors of the trustee company if any, is involved in any litigation connected with the securities market which may have an adverse bearing in the business of the venture capital fund.

3. The directors of its trustee company or the trustees have not at anytime being convicted of an offense involving moral turpitude or any economic offense.
In both cases, the company or the trust must not have already applied for certificate from SEBI or its certificate must not have been suspended by SEBI or cancelled by SEBI and the applicant must be a fit and proper person.

3. Conditions

The certificate granted shall be subject to the following conditions.

1. The venture capital fund shall abide by the provisions of the SEBI Act, the government of India guidelines and these regulations.
2. The venture capital fund shall not carry on any other activity other than that of a venture capital fund.
3. The venture capital fund shall inform SEBI in writing of any information or details previously submitted to SEBI which have changed after grant of the certificate.
4. If the information or details submitted are found to be false or are misleading in any particular manner, suitable penal action can be taken.

4. Investment Conditions and restrictions

A venture capital fund may raise money from any source, whether Indian, foreign or non resident Indian. No venture capital fund shall accept any investment from any investor less than Rs 5,00,000. However this condition is not applicable to employees or the principal officer or director of the venture capital fund or director of the trustee company or trustee to non resident Indians or persons or institutions of foreign origin.

For the purpose of these regulations, fund raised means actual money raised from investors for subscribing to the securities of the venture capital fund
and includes money that is raised from the author of the trust (in case the venture capital fund has been established as a trust) but does not include the paid up capital of the trustee company, if any.

All investments made or to be made by venture capital fund will be subject to the following restriction

Eligibility criteria under the VCFR has been relaxed to allow willing private sector participants to enter into the venture capital industry. In the Guidelines-1988, earlier this activity was restricted to 'All-India public sector financing institutions, State Bank of India and other scheduled banks, including foreign banks operating in India, and the subsidiaries of the above, subject to RBI permission for banks.

Under regulation 4 of the VCFR, a company or a trust, is eligible to establish a venture capital fund.

5. Mobilisation of Resources by VCF

In addition to the corpus of the VCF, the additional capital could be mobilised by venture capitalist in the following manner:

a. Investment by individual investors Indian, foreign or non-resident investors can invest their monies in venture capital fund. However, such investments shall not be less than Rs 5 lakh (Rs 0.5 million).

However, the above restriction of Rs 5 lakh is not applicable to (a) employees or principal officer or directors of VCF or trustees; (b) NRIs or persons or institutions of foreign origin. However, foreign equity
participation or NRI investment shall be regulated as per the provisions of Foreign Exchange Management Act, 1999 and the RBI Guidelines thereto.

b. **Inviting subscription from public** A VCF is prohibited raising money from against its securities or units from the general public. In other words, a VCF cannot issue any document or advertisement inviting offers from public for the subscription or purchase of its securities or units. This restriction was not in force in Government Guidelines-1988.

c. **Raising funds through private placement** A VCF may receive monies for investment in the venture capital fund through private placement of its securities or units. Such private placement can be done with institutions and highly valued investors. The private placement will be done only through a placement memorandum duly approved by SEBI and through private circulation only after the expiry of 21 days of its submission to SEBI.

This facility of raising funds through private placement to finance VCF was available under Government Guidelines-1988.

6. Obligations and Responsibilities

VCFs are required to maintain books and records for a period of ten years and such books shall depict true picture of the affairs of VCF. It shall also submit to SEBI the information as required and reports relating to its activity as VCF.

7. Winding Up

For winding up of the VCF, different sets of procedures are to be followed depending upon its form of organisation. If VCF is a trust under the trust laws, then the scheme of VCF shall be wound up when the period of
such scheme expires. VCF scheme can be wound up if the trustees so opine to wind up in the interest of investors in the units and inform of the same to SEBI, VCF can also be wound up if 15 per cent of the investors in the scheme pass resolution at a meeting of unit holders to wind up the scheme and inform the SEBI accordingly of the same. SEBI may also direct winding up in the interest of the investors. Thus, it is the trustees or investors who can wind up the scheme.

In the case of the VCF set up as a company it shall be wound up as per the provisions of the Companies Act, 1956.

8. Other Provisions

SEBI-VCF Regulations provide for inspection and investigation and procedure for action against the VCF in case of default.

II. INCOME TAX BENEFITS

In order to encourage the development of venture capital funds, the Income Tax Act, 1961 exempts the income of a venture capital fund from income tax. Any income by way of dividend's (other than dividend from domestic companies, dividend from mutual funds and UTI dividend, which are exempt for all assessees) or long term capital gains of a venture capital fund or a venture capital company from investments made by way of equity shares in a venture capital undertaking will be exempt from income tax.

However for claiming the benefit of this exemption, the venture capital fund or venture capital company is approved for the by the Central Government on application made to it in accordance to the rules made for
such purpose and satisfies the prescribed conditions. This approval by the Central Government shall at one time have effect for not more than three assessment years specified in the order of approval.

For the purposes of the Income Tax Act, 1961, venture capital fund means a fund operating under a trust deed, registered under the provisions of the Indian Registration Act, 1908 and established to raise money by the trustees for investments, mainly by the way of acquiring equity shares of a venture capital undertaking in accordance with the prescribed guidelines.

Venture capital company means a company which has made investment by way of acquiring equity shares of venture capital undertaking in accordance with the prescribed guidelines.

Venture capital undertaking means such domestic company whose shares are not listed on a recognized stock exchange in India and which is engaged in the business of software, information technology, production of basic drugs in the pharmaceutical sector, bio-technology, agriculture and allied sectors or such other sector as may be notified by the Central Government in this behalf or in the production or manufacture in any article or substance for which patent has been granted to the national research laboratory or any other scientific research of institution approved by the department of science and technology.

In other words, the funding agency has been called the venture capital fund or venture capital company and the new enterprise has been called the venture capital undertaking.
It is noteworthy that SEBI guidelines do not prescribe the industries or sectors in which a venture capital fund has to operate. Whereas under the Income Tax Act, 1961, tax exemption will be available only if the venture capital undertaking is engaged in the aforesaid industries only.

The CBDT has prescribed certain guidelines for approval of a venture capital fund or company for claiming tax exemption. The concerned authority to whom application for approval is to be made and which grants the approval is the Director of Income Tax (Exemption) having jurisdiction over the venture capital fund or the venture capital company.

Briefly, these guidelines are as follows:

- The application for approval shall be made in Form 56A by the venture capital fund or venture capital company to the concerned Director of Income Tax (Exemption).
- Every application must be made in any previous year in which any income by way of dividend or long term capital gains is earned by a venture capital fund or a venture capital company from investments made by the way of equity shares in the venture capital undertaking.
- Every application for approval shall be accompanied by the following documents
  - A copy of trust deed or certificate of incorporation under the Companies Act.
  - Balance Sheets and Profit and Loss Accounts for three previous years immediately preceding the year in which the application, is made.
  - Form 56B and 56C duly filled in and signed by the applicant.
  - A copy of the certificate of registration from SEBI
- The Director of Income Tax (Exemption) shall approve the venture capital fund or the venture capital company, as the case may be, subject to the following conditions
a. The venture capital fund or the venture capital company must be registered with SEBI.

b. Every venture capital fund / company invests an amount of not less than 80% of his total money raised for investment by way of acquiring equity shares of the venture capital undertaking in the following manner:

- 20% or more of such money must be invested during or before the end of the previous year of which the application is made by way of acquiring equity shares of the venture capital undertaking.
- 50% or more of such money shall be invested during or before the end of the previous year succeeding previous year in which investment of 20% referred to in sub-clause 1 has been made by way of acquiring equity shares of the venture capital undertaking.
- 80% or more of such money shall be invested during or before the end of the previous year immediately succeeding the previous year in which 50% investment referred to in above sub-clause 2 has been made by acquiring equity shares of the venture capital undertaking.

c. A venture capital fund or venture capital company, as the case may be, shall not invest more than 20% of his total money raised or total paid up capital in one venture undertaking.

d. A venture capital fund or a venture capital company, as the case may be, shall not make an investment of more than 40% of the equity capital of venture capital undertaking.

e. Every venture capital fund or venture capital company shall maintain books of accounts and shall get books of accounts audited by a chartered accountant and furnish audit report duly signed and verified by the chartered accountant to the Director of Income Tax (Exemption) before the due date of filling return under section 139(1).
The Director of Income Tax (Exemption) shall pass an approval or refusing approval of venture capital fund or venture capital company as the case may be. However, before refusing to grant approval, the capital fund or venture capital company, as the case may be, shall be given an opportunity to make its representation. Refusal to grant approval can be made only with the concurrence of the Director General of Income Tax (Exemption).

The Director of Income Tax (Exemption) shall withdraw the approval granted if the venture capital fund or venture capital company violates any of the aforesaid guidelines or violates the provisions of the Income Tax Act or rules there under or if the certificate of registration granted by SEBI is suspended or cancelled by SEBI.

III. CENTRAL GOVERNMENT POLICY AND GUIDELINES

The central government has framed guidelines for promoting and regulating the growth of venture capital industry. The guidelines issued by the central government on 25 November 1988, vested requisite powers in the Department of Economic Affairs, Ministry of Finance, or such authority as may be nominated by the government. Initially such authority was vested with the Controller of Capital Issues (CCI). The sponsor of venture capital fund was required to make applications with a suitable explanatory note and details of the proposal to CCI/Joint Secretary (Investments) in the Department of Economic Affairs.

With the abolition of the office of CCI with effect from May 1992, the powers of CCI were vested in SEBI. SEBI Act, 1992, was amended on 25 January 1995 (Securities Laws (Amendment) Act, 1995) empowering SEBI to register and regulate the working of venture capital funds. SEBI is to be
approached for approval to establish a venture capital company or venture capital fund or for the issue of capital by venture capital companies. The role of SEBI is discussed previously in this chapter in connection with venture capital funds. Presently, the discussion centres on the provision of guidelines for regulating venture capital funds in India. The government guidelines were revoked in 1995 when venture capital regulations were being formulated by SEBI. However, a study of the said guidelines presents a historical background to the regulatory processes of the industry.

The Government guidelines envisaged a scheme under which VCCs/VCl's were able to invest in new companies and became eligible for concessional treatment of capital gains available to non-corporate entities. The venture capital assistance under the scheme covered enterprises fulfilling the following parameters:

- **Size**: Total investment not to exceed Rs 100 million.

- **Technology**: New or relatively untried or very closely held technology, or technology which was being taken from pilot to commercial stage or which incorporated some significant improvement over the existing ones in India.

- **Promoters/Entrepreneurs**: Relatively new, professional or technically qualified, with inadequate resources or backing to finance the project.

- **Enterprises**: Assistance was expected to be given to those enterprises where the risk element was comparatively high due to the technology involved being relatively new, untried or very closely held and/or entrepreneurs being relatively new and not affluent, though otherwise qualified; and the size being modest.

- **Assistance**: Assistance was to be mainly in the form of equity support, though loan support to supplement this might also be done.
The minimum size of a VCC/VCF was expected to be Rs 10.00 crores. If it was desired to raise funds from the public, the promoters would share not less than 40 per cent of the capital. Funds might be raised through public issue and/or private placement to finance VCF/VCCs. NRI investments were to be permitted, up to 74 per cent on non-repatriable basis and up to 25 per cent on a repatriable basis.

The VCC/VCF was expected to invest at least 75 per cent of its funds in venture capital activities. During the first 12 months, any permissible investment might be made (including leasing up to 15 per cent of the funds) but a level of 30 per cent was to be reached for venture capital activity by the end of the second year, 60 per cent by the end of the third year and 75 per cent by the end of the fifth year of operations.

The preferential tax treatment would be available to the approved venture capital company/fund only in respect of financing of such assisted units as were eligible to be treated as venture capital units. For this purpose, the venture capital unit seeking equity support from the VCC/VCF would have to obtain a letter of eligibility from IDBI/ICICI/IFCI or any such agency as may be nominated by the Government of India.

Government Policy

The Central Government policy on venture capital finance is also projected in the Research & Development (Cess) Act, 1986, which facilitates formation of the venture capital fund at the national level. The statement of objects and reasons states that the fund shall be utilised for providing further incentives for the commercial application of indigenously developed
technology and to adopt imported technology for wider domestic applications. This objective is reiterated in the Preamble which mentions that for this purpose, a cess is being levied and collected on all payments made for import of technology.

The clause(namely cl.(h) of s.2) defines technology in the following terms:

"technology" means any special or technical knowledge or any special service required for any purpose whatsoever by an industrial concern under any foreign collaboration, and includes designs, drawings, publications and technical personnel".

Thus, technology here not only covers technical (or special) know-how and (technical) designs, drawings and publications but also includes technical personnel (that is to say the work rendered by them) and any special service required for any purpose by the industrial concern (seeking assistance from the VCF). This broader connotation is relevant for deciding whether a payment remitted abroad is for the import of technology or otherwise. The definition of technology has been framed in broader terms, particularly with a view to cover remittances for the import of every possible manner of technical know how. However, no cess is required to be paid on remittance of import of plant, machinery, equipment or other goods.

The rate of cess has been fixed at 5 per cent of the amount of payments (whether in Indian or foreign currency) for import of technology. The amount of cess collected being a form of tax, is first credited to the consolidated fund of India in view of Article 266 of the constitution of India and, when Parliament passes Appropriation Act(s) providing for appropriation from the consolidated fund, Government transfers such moneys ( minus collection expenses) to IDBI
for being credited to the venture capital fund set up under the R&D cess Act. This VCF forms part of the Development Assistance Fund of IDBI, established under section 14 of the IDBI Act, for the purpose of extending assistance (to any industrial concern) which is not likely to be granted by banking or financial institutions, or other agencies, in the ordinary course of business, but which is necessary as a matter of priority in the interest of the industrial development of the country. The result of linking the VCF with DAF would be that the IDBI would not be in a position to help any concern from the VCF unless the above two conditions are fulfilled namely non-availability of support from other sources and need for priority treatment in the context of industrial development. However, this need no be viewed as a detracting factor because in cases where these two conditions are not satisfied, IDBI may be inclined to support the project from other resources.

IV. ROLE OF IVCA

Indian Venture Capital Association (IVCA) is a voluntary organisation formed by the Indian Venture Capital Companies/Venture Capital Funds which acts as a representative and as a self-regulatory body of venture capitalists in India on the lines of British Venture Capital Association (BVCA).

The main objectives of the IVCA are to bring about better coordination among VCCs/VCFs, help in setting up professional standards and practices in venture capital industry, organise and conduct special training programmes for personnel engaged in venture capital activities and to represent the interests of VCCs to the government and other regulatory bodies.
IVCA is currently building a database on the venture capital industry in India to enable the dissemination of information to government agencies, international venture capital organisations/companies and others who are interested in the Indian venture capital industry. IVCA has made many suggestions to the government and SEBI regarding changes required to be made in the venture capital guidelines. But after 1998, IVCA activities are not satisfactory.

REPORT OF K.B. CHANDRASEKHAR COMMITTEE ON VENTURE CAPITAL

I. Why venture capital

The venture capital industry in India is still at a nascent stage. With a view to promote innovation, enterprise and conversion of scientific technology and knowledge based ideas into commercial production, it is very important to promote venture capital activity in India. India's recent success story in the area of information technology has shown that there is a tremendous potential for growth of knowledge based industries. This potential is not only confined to information technology but is equally relevant in several areas such as biotechnology, pharmaceuticals and drugs, agriculture, food processing, telecommunications, services, etc. Given the inherent strength by way of its skilled and cost competitive manpower, technology, research and entrepreneurship, with proper environment and policy support, India can achieve rapid economic growth and competitive global strength in a sustainable manner.

A flourishing venture capital industry in India will fill the gap between the capital requirements of technology and knowledge based startup enterprises and funding available from traditional institutional lenders such as banks. The gap
exists because such startups are necessarily based on intangible assets such as human capital and on a technology-enabled mission, often with the hope of changing the world. Very often, they use technology developed in university and government research laboratories that would otherwise not be converted to commercial use. However, from the viewpoint of a traditional banker, they have neither physical assets nor a low-risk business plan. Not surprisingly, companies such as Apple, Exodus, Hotmail and Yahoo, to mention a few of the many successful multinational venture-capital funded companies, initially failed to get capital as startups when they approached traditional lenders. However, they were able to obtain finance from independently managed venture capital funds that focus on equity or equity-linked investments in privately held, high-growth companies. Along with this finance came smart advice, hand-on management support and other skills that helped the entrepreneurial vision to be converted to marketable products.

Beginning with a consideration of the wide role of venture capital to encompass not just information technology, but all high-growth technology and knowledge-based enterprises, the endeavor of the Committee has been to make recommendations that will facilitate the growth of a vibrant venture capital industry in India. The report examines (1) the vision for venture capital (2) strategies for its growth and (3) how to bridge the gap between traditional means of finance and the capital needs of high growth startups.

II. Critical factors for success of venture capital industry

While making the recommendations the Committee felt that the following factors are critical for the success of the VC industry in India:
a. The regulatory, tax and legal environment should play an enabling role. Internationally, venture funds have evolved in an atmosphere of structural flexibility, fiscal neutrality and operational adaptability.

b. Resource raising, investment, management and exit should be as simple and flexible as needed and driven by global trends.

c. Venture capital should become an institutionalized industry that protects investors and investee firms, operating in an environment suitable for raising the large amounts of risk capital needed and for spurring innovation through startup firms in a wide range of high growth areas.

d. In view of increasing global integration and mobility of capital it is important that Indian venture capital funds as well as venture finance enterprises are able to have global exposure and investment opportunities.

e. Infrastructure in the form of incubators and R&D need to be promoted using Government support and private management as has successfully been done by countries such as the US, Israel and Taiwan. This is necessary for faster conversion of R & D and technological innovation into commercial products.

Recommendations

1. Multiplicity of regulations - need for harmonisation and nodal Regulator:

Presently there are three set of Regulations dealing with venture capital activity i.e. SEBI (Venture Capital Regulations) 1996, Guidelines for Overseas Venture Capital Investments issued by Department of Economic Affairs in the MOF in the year 1995 and CBDT Guidelines for Venture Capital Companies in
1995 which was modified in 1999. The need is to consolidate and substitute all these with one single regulation of SEBI to provide for uniformity, hassle free single window clearance. There is already a pattern available in this regard; the mutual funds have only one set of regulations and once a mutual fund is registered with SEBI, the tax exemption by CBDT and inflow of funds from abroad is available automatically. Similarly, in the case of FIIs, tax benefits and foreign inflows/outflows are automatically available once these entities are registered with SEBI. Therefore, SEBI should be the nodal regulator for VCFs to provide uniform, hassle free, single window regulatory framework. On the pattern of FIIs, Foreign Venture Capital Investors (FVCIs) also need to be registered with SEBI.

2. Tax pass through for Venture Capital Funds

VCFs are a dedicated pool of capital and therefore operates in fiscal neutrality and are treated as pass through vehicles. In any case, the investors of VCFs are subjected to tax. Similarly, the investee companies pay taxes on their earnings. There is a well established successful precedent in the case of Mutual Funds which once registered with SEBI are automatically entitled to tax exemption at pool level. It is an established principle that taxation should be only at one level and therefore taxation at the level of VCFs as well as investors amount to double taxation. Since like mutual funds VCF is also a pool of capital of investors, it needs to be treated as a tax pass through. Once registered with SEBI, it should be entitled to automatic tax pass through at the pool level while maintaining taxation at the investor level without any other requirement under Income Tax Act.
3. Mobilisation of Global and Domestic resources

(A) Foreign Venture Capital Investors (FVCIs):

Presently, FIIs registered with SEBI can freely invest and disinvest without taking FIPB/RBI approvals. This has brought positive investments of more than US $10 billion. At present, foreign venture capital investors can make direct investment in venture capital undertakings or through a domestic venture capital fund by taking FIPB / RBI approvals. This investment being long term and in the nature of risk finance for start-up enterprises, needs to be encouraged. Therefore, at least on par with FIIs, FVCIs should be registered with SEBI and having once registered, they should have the same facility of hassle free investments and disinvestments without any requirement for approval from FIPB / RBI. This is in line with the present policy of automatic approvals followed by the Government. Further, generally foreign investors invest through the Mauritius-route and do not pay tax in India under a tax treaty. FVCIs therefore should be provided tax exemption. This provision will put all FVCIs, whether investing through the Mauritius route or not, on the same footing. This will help the development of a vibrant India-based venture capital industry with the advantage of best international practices, thus enabling a jump-starting of the process of innovation.

The hassle free entry of such FVCIs on the pattern of FIIs is even more necessary because of the following factors:

i. Venture capital is a high risk area. In out of 10 projects, 8 either fails or yield negligible returns. It is therefore in the interest of the country that FVCIs bear such a risk.

ii. For venture capital activity, high capitalisation of venture capital companies is essential to withstand the losses in 80% of the projects. In India, we do not have such strong companies.
iii. The FVCIs are also more experienced in providing the needed managerial expertise and other supports.

B. **Augmenting the Domestic Pool of Resources:**

The present pool of funds available for venture capital is very limited and is predominantly contributed by foreign funds to the extent of 80 percent. The pool of domestic venture capital needs to be augmented by increasing the list of sophisticated institutional investors permitted to invest in venture capital funds. This should include banks, mutual funds and insurance companies up to prudential limits. Later, as expertise grows and the venture capital industry matures, other institutional investors, such as pension funds, should also be permitted. The venture capital funding is high-risk investment and should be restricted to sophisticated investors. However, investing in venture capital funds can be a valuable return-enhancing tool for such investors while the increase in risk at the portfolio level would be minimal. Internationally, over 50% of venture capital comes from pension funds, banks, mutual funds, insurance funds and charitable institutions.

4. **Flexibility in Investment and Exit**

A. Allowing multiple flexible structures:

Eligibility for registration as venture capital funds should be neutral to firm structure. The government should consider creating new structures, such as limited partnerships, limited liability partnerships and limited liability corporations. At present, venture capital funds can be structured as trusts or companies in order to be eligible for registration with SEBI. Internationally, limited partnerships, Limited Liability Partnership and limited liability corporations have provided the necessary flexibility in risk-sharing, compensation arrangements amongst investors and tax pass through. Therefore,
these structures are commonly used and widely accepted globally specially in USA. Hence, it is necessary to provide for alternative eligible structures.

B. Flexibility in the matter of investment ceiling and sectoral restrictions:

70% of a venture capital fund's investible funds must be invested in unlisted equity or equity-linked instruments, while the rest may be invested in other instruments. Though sectoral restrictions for investment by VCFs are not consistent with the very concept of venture funding, certain restrictions could be put by specifying a negative list which could include areas such as finance companies, real estate, gold-finance, activities not legally permitted and any other sectors which could be notified by SEBI in consultation with the Government. Investments by VCFs in associated companies should also not be permitted. Further, not more than 25% of a fund's corpus may be invested in a single firm. The investment ceiling has been recommended in order to increase focus on equity or equity-linked instruments of unlisted startup companies. As the venture capital industry matures, investors in venture capital funds will set their own prudential restrictions.

C. Changes in buy back requirements for unlisted securities:

A venture capital fund incorporated as a company/venture capital undertaking should be allowed to buyback upto 100% of its paid up capital out of the sale proceeds of investments and assets and not necessarily out of its free reserves and share premium account or proceeds of fresh issue. Such purchases will be exempt from the SEBI takeover code. A venture-financed undertaking will be allowed to make an issue of capital within 6 months of buying back its own shares instead of 24 months as at present. Further, negotiated deals may be permitted in Unlisted securities where one of the parties to the transaction is VCF.
D. Relaxation in IPO norms:

The IPO norms of 3 year track record or the project being funded by the banks or financial institutions should be relaxed to include the companies funded by the registered VCFs also. The issuer company may float IPO without having three years track record if the project cost to the extent of 10% is funded by the registered VCF. Venture capital holding however shall be subject to lock in period of one year. Further, when shares are acquired by VCF in a preferential allotment after listing or as part of firm allotment in an IPO, the same shall be subject to lock in for a period of one year. Those companies which are funded by Venture capitalists and their securities are listed on the stock exchanges outside the country, these companies should be permitted to list their shares on the Indian stock exchanges.

E. Relaxation in Takeover Code:

The venture capital fund while exercising its call or put option as per the terms of agreement should be exempt from applicability of takeover code and 1969 circular under section 16 of SC(R)A issued by the Government of India.

F. Issue of Shares with Differential Right with regard to voting and dividend:

In order to facilitate investment by VCF in new enterprises, the Companies Act may be amended so as to permit issue of shares by unlisted public companies with a differential right in regard to voting and dividend. Such a flexibility already exists under the Indian Companies Act in the case of private companies which are not subsidiaries of public limited companies.

G. QIB Market for unlisted securities:

A market for trading in unlisted securities by QIBs be developed.
H. NOC Requirement:

In the case of transfer of securities by FVCI to any other person, the RBI requirement of obtaining NOC from joint venture partner or other shareholders should be dispensed with.

I. RBI Pricing Norms:

At present, investment/disinvestment by FVCI is subject to approval of pricing by RBI which curtails operational flexibility and needs to be dispensed with.

5. Global integration and opportunities

a. Incentives for Employees: The limits for overseas investment by Indian Resident Employees under the Employee Stock Option Scheme in a foreign company should be raised from present ceilings of US$10,000 over 5 years, and US$50,000 over 5 years for employees of software companies in their ADRs/GDRs, to a common ceiling of US$100,000 over 5 years. Foreign employees of an Indian company may invest in the Indian company to a ceiling of US$100,000 over 5 years.

b. Incentives for Shareholders: The shareholders of an Indian company that has venture capital funding and is desirous of swapping its shares with that of a foreign company should be permitted to do so. Similarly, if an Indian company having venture funding and is desirous of issuing an ADR/GDR, venture capital shareholders (holding saleable stock) of the domestic company and desirous of disinvesting their shares through the ADR/GDR should be permitted to do so. Internationally, 70% of successful startups are acquired through a stock-swap transaction rather
than being purchased for cash or going public through an IPO. Such flexibility should be available for Indian startups as well. Similarly, shareholders can take advantage of the higher valuations in overseas markets while divesting their holdings.

c. Global investment opportunity for Domestic Venture Capital Funds (DVCF): DVCFs should be permitted to invest higher of 25% of the fund's corpus or US $10 million or to the extent of foreign contribution in the fund's corpus in unlisted equity or equity-linked investments of a foreign company. Such investments will fall within the overall ceiling of 70% of the fund's corpus. This will allow DVCFs to invest in synergistic startups offshore and also provide them with global management exposure.

6. Infrastructure and R&D

Infrastructure development needs to be prioritized using government support and private management of capital through programmes similar to the Small Business Investment Companies in the United States, promoting incubators and increasing university and research laboratory linkages with venture-financed startup firms. This would spur technological innovation and faster conversion of research into commercial products.

7. Self Regulatory Organisation (SRO)

A strong SRO should be encouraged for evolution of standard practices, code of conduct, creating awareness by dissemination of information about the industry.

Implementation of these recommendations would lead to creation of an enabling regulatory and institutional environment to facilitate faster growth of
venture capital industry in the country. Apart from increasing the domestic pool of venture capital, around US$ 10 billion are expected to be brought in by offshore investors over 3/5 years on conservative estimates. This would in turn lead to increase in the value of products and services adding up to US$100 billion to GDP by 2005. Venture supported enterprises would convert into quality IPOs providing over all benefit and protection to the investors. Additionally, judging from the global experience, this will result into substantial and sustainable employment generation of around 3 million jobs in skilled sector alone over next five years. Spin off effect of such activity would create other support services and further employment. This can put India on a path of rapid economic growth and a position of strength in global economy.

INCENTIVES FOR PROMOTING VENTURE CAPITAL IN 2000

The then Indian Finance Minister, Mr. Yashwant Sinha said in his Budget 2000 speech that for promoting high technology sectors and supporting first generation entrepreneurs, there is an acute need for higher investment in venture capital activities. He introduced some major liberalisation of tax treatment of VCFs and simplification procedures.

- SEBI was recognized as the single nodal agency.

- New clause (23 FB) in Section 10 of the Income Tax Act was introduced with effect from 1.3.2000. This clause stated that any income of VCC/VCF from any investment made in Venture Capital undertakings would not be included in computing total income.

- Section 115U was introduced from assessment year 2000-2001 to establish VC pass through. This means that Venture capital profits
will not be taxed twice. VCF (registered with SEBI) is exempted (subject to certain conditions) and venture capital is alone taxed.

- The Finance Bill proposes to amend Section 10 (23 FB) so as to provide that a VCC/VCF will continue to be eligible for exemption under Section 10 (23 FB) even if the shares of the venture capital undertaking, in which the VCC/VCF has made the initial investment, are subsequently listed in a recognized stock exchange in India.

- Tax holiday for 10 years for software and services sector 100% exemption of export profits.

- Introduction of Sweat equity.

- Allowing VCFs to offset losses incurred in one company against the profits from another company.

REGULATORY INCONSISTENCIES

Even among the different set of rules and regulations there are inconsistencies. While SEBI permits venture capital investments in equity and equity related instruments of unlisted companies and also in financially weak and sick units whose shares are listed or unlisted, the Government and Income Tax department restrict such investments only in the equity of unlisted companies. SEBI regulations provide that at least 80% of the funds should be invested in the venture capital companies and no other limits are prescribed. But the income Tax rules provide that VCF shall invest only up to 25% of its corpus in a single company. SEBI and Government of India guidelines do not provide for any sectoral restrictions for investment except investment in
financial services sector. But the Income Tax rules provide that VCF can make investments in specified sectors for claiming tax exemptions. The coexistence of multiple sets of guidelines/requirements of different organizations has created inconsistencies and also the negative perception about the regulatory environment in India.

CONCLUSION

Venture capital financing in India in 1983 with the main objective of developing indigenous technology and the efficient absorption and adoption of imported technology appropriate to national priorities and resources. Traditionally the role of venture capital was an extension of the development financial institutions and banks. The development of venture capital industry was very slow and tardy. It needs a congenial environment to grow. The new guidelines by the Government of India in 1995 for overseas investors and that of SEBI in 1996 have activated the venture capital industry by permitting the FVCIs and private sector to enter the industry on a large scale. Shri.R.B.Chandrasekhar Committee on venture capital has reported favourably about the great potentials for the growth of industry. However, the report has stressed the need for making a lot of changes in the regulatory, legal, and tax framework and other environmental aspects.