# Venture Capital Regulations in India

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***"There is a tide in the affairs of men, which taken at the flood, leads on to fortune........ And we must take the current when it serves, or lose our ventures."***

- William Shakespeare

Growth is the process that only happens when the untread is tried and the undone is materialized. For any new venture we undertake there is always apprehension of misses than hitting the bull's eye and this apprehension for years has curbed the entrepreneurs from innovating and growing. Venture Capital is the conduit for giving the entrepreneurs wings to fly when they are willing to jump of the cliff.

Simply put, Venture Capital is a term coined for the capital required by an entrepreneur to 'venture' into something new, promising and unconventional. Investing in a budding company has always been a risky proportion for any financier. The risk of the business failure and the apprehensions of an all together new project clicking weighed down the small entrepreneurs to get the start-up fund. The Venture Capitalists or the angel investors then came to the forefront with an appetite for risk and willingness to fund the ventures.

***How does it work?*** Venture Capital financing is a process whereby funds are pooled in for a period of around 10 years and investing it in venture capital undertakings for a period of 3 to 5 years with an expectation of high returns. To protect the funds of the investors against the risk of losses, venture capital fund provides its expertise, undertake advisory function and invest in the 'patient capital' of the undertaking – equities.

Venture Capital financing had been a popular source of funding in many countries and served as a lucrative bait to create a similar industry in India as well.

***Regulations of Venture Capital:***

VCF are regulated by the SEBI (Venture Capital Fund) Regulations, 1996. The regulation clearly states that any company or trust proposing to carry on activity of a VCF shall get a grant of certificate from SEBI. Section 12 (1B) of the SEBI Act also makes it mandatory for every domestic VCF to obtain certificate of registration from SEBI in accordance with the regulations. Hence there is no way that an Indian Venture Capital Fund can exist outside SEBI Regulations. However registration of Foreign Venture Capital Investors (FVCI) is not mandatory under the FVCI regulations.

A VCF and registered FVCI enjoy several benefits:

- No prior approval required from the Foreign Investment Promotion Board (FIPB) for making investments into Indian Venture Capital Undertakings (VCUs).
- As per the Reserve Bank of India Notification No. FEMA 32 /2000-RB dated December 26, 2000, an FVCI can purchase/ sell securities/ investments at a price that is mutually acceptable to the parties and there is no ceiling or floor restriction applicable to them.
- A registered FVCI has been granted the status of Qualified Institutional Buyer (QIB), so they can subscribe to the share capital of a VCU at the time of intial public offer. A lock-in of one year is applicable to the shares subscribed in an IPO.
- The lock-in period applicable for the pre-issue share capital from the date of allotment, under the SEBI (Disclosure and Investor Protection) Guidelines, 2000 is not applicable in case of a registered FVCI and VCF.
- Under the SEBI (Substantial Acquisition of Shares and Takeover) Regulations, 1997 if the promoters want to buy back the shares from FVCIs, it would not come under the public offer requirements.

***Structure of a VCF:***

The regulations in India have been carefully drafted but then have left ambiguity in understanding to many. Though the laws relating are not complex but then they do not lay down clear cut laws; susceptible to interpretations and discussions.

Section 2(m) defines a VCF is a corpus of funds created by raising funds in a specific manner to be invested in a manner as specified in the regulations. This means any activity beyond the periphery of what is laid in the charter is prohibited. A VCF can be created in a form of a 1) trust, 2) company including 3) a body corporate. This means that no matter what the form of a VCF is the core substance shall remain the same. The VCF is segregated into "schemes" in which the funds are invested. The scheme relates to investing the money into venture capital undertakings as defined under sec 2 (n) of the regulations. A VCF raises money from the investors in the form of "units" (discussed below) to be invested in these schemes. Chapter III and IV lay down the restrictions and prohibitions on raising and investment of funds by a VCF.

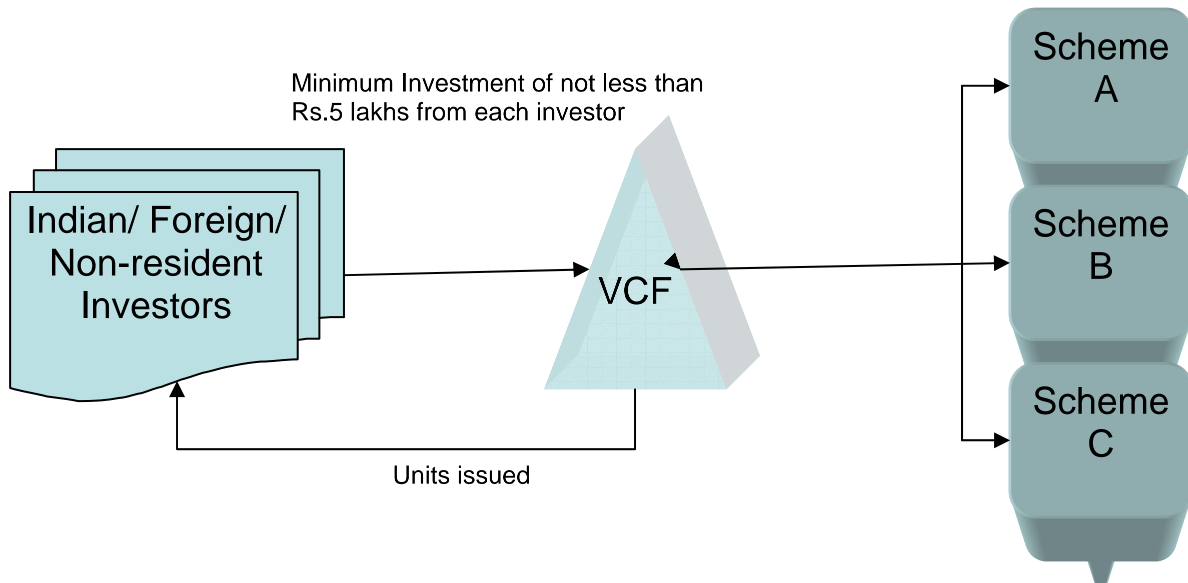
From the above laid structure the following few key features of a VCF have emerged:

- A VCF raises funds in the form of "units." Section 2(l) defines "units" as "*beneficial interest of the investors in the scheme or funds floated by a trust or issued by a company including a body corporate.*" Chapter III says that these funds can be raised from Indian, foreign or non-resident investors by the way of issuance of units. Chapter VI prohibits public offers for inviting subscription or purchase of units from the public. The above elucidated two things 1) the units are the "*beneficial interest*" of the investors and that the VCF holds only legal interest and 2) that the VCF is a channel of investing the investors' money in various *"schemes."*

- The regulations have crisply laid down the core substance of the VCF. The regulations lay down that the VCF can be constituted in form of a trust or company including a body corporate but have rested in the beneficial interest in the hands of the investors and legal interest in the hands of the managers of the fund. In case of a trust form of VCF, it is evident that the funds pooled are held by the trustees and that they have only legal interest in the raised funds, so this raises no confusions. However, in case of a company/ body corporate also the company holds only legal interest in the fund. Unlike a company, fund is raised – scheme specific and cannot be used by the company in any other manner or for any other purpose and that the unit holders are the beneficiaries, reducing the status of the company to having only fiduciary interest in the fund. Thus, no matter what form a VCF is constituted in the essence would be that of a trust.

This further raises question as to what is the interest of the trust or company (including body corporate) in managing the schemes. Section 2 (hh) of the regulation defines investible funds as *"corpus of the fund net of expenditure for administration and management of fund."* So the managers of the fund receive fees for the management of the VCF business. The regulations expressly do not specify the permissible or prohibited quantum of the fees. This clears the sham, surfacing the clear cut view that the VCF may be dressed in any form raising doubts on interpretations, the conclusion is that the core substance prevails.

***Investment conditions and restrictions:***

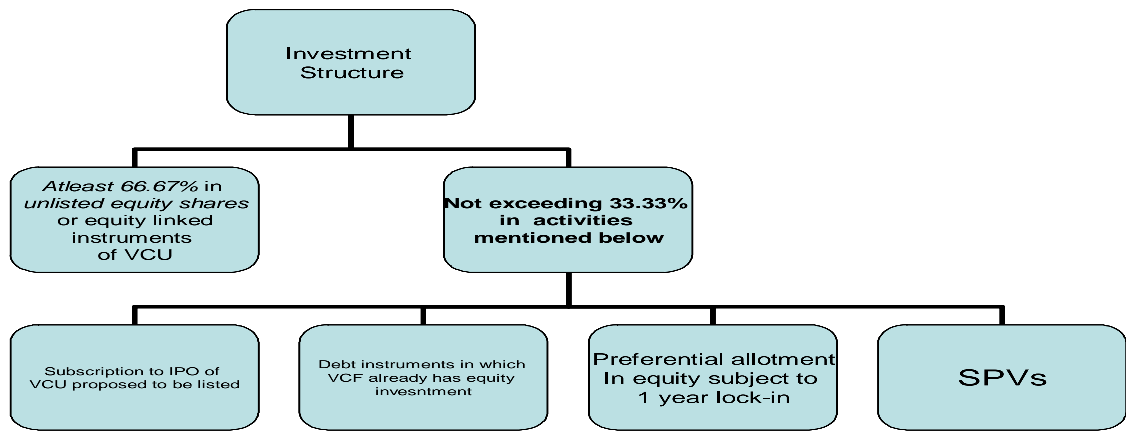



A VCF shall accept not less than Rs. 5 lakhs as minimum investment from each investor by way of issue of units and the VCF in turn will invest the pooled funds in various schemes with a minimum contribution in each scheme of Rs. 5 crores. There are further restrictions on the allocation of funds by a VCF in various VCUs as illustrated in the diagram below.

Not more than 25% of the corpus can be invested in one VCU

Investment in Foreign Companies subject to RBI guidelines

Shall not invest in associate companies




From taxation point of view, section 10(23F), 10(23FA) and 10(23FB) of the Income Tax Act, 1961 further makes things clear. These sections clearly state that the income of the VCF received in the form of dividend or long term capital gain from any venture capital undertaking will not form a part of the total income of the VCF for taxability purposes as well. Section 115 U of the Income Tax Act specify that the income received from the investment made in any Venture Capital Fund shall be chargeable to income tax in the hands of the investor. This means that the venture capital fund or company enjoys the pass through status for taxes on the income earned by way of investment in venture capital undertakings. They are only appropriating/ allocating the funds for which they receive a management fees.

***Is VCF an NBFC? :***

NBFCs as defined under the Reserve Bank of India Act, Chapter IIIB, section 45I -

*(f)* ‘‘non-banking financial company’’ means–

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*(ii)* a non-banking institution which is a company and which has as its principal business the receiving of deposits, under any scheme or arrangement or in any other manner, or lending in any manner;

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The definition of deposits includes receipt of money by the way of deposits or loan or in any other form but does not include amount raised by the way of share capital. So in light of the above definitions it becomes clear that a VCF is not an NBFC. Also the VCF regulations have in a very clear cut way defined how a venture capital could raise money and make investments. Besides the various statutory requirements for NBFCs under Section 45IA and other sections are not applicable to VCFs.

***Conclusion:***

The industry has a great potential for growth and the recent amendments and regulatory changes are only an indication that the Venture Capital Industry in India is moving in the direction of growth but there continues to be room for development.