INDIA

Venture Capitalism[1]

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1. INTRODUCTION

Venture capital (VC) investment performs the role of a catalyst, speeding the' transformation of a developing economy into a dynamic economy, enabling it to face the growing competition brought about due to globalization. In the last decade, due to the liberalization of the Indian economy, venture capitalists worldwide realized the vast potential for investments in Indian industries due to the significant advantages amongst others like cost efficiency, quality of human capital, strategic geographic location, humongous market, etc. Though it must be said, for a country like India, which largely owes its progress to new technology developments, VC has come late in the day.

The Indian VC industry is the result of an iterative learning process, and it is still in its infancy. A recent 6ECD (2000) report identified VC as a critical component for the success of entrepreneurial high-technology firms and recommended that all nations consider strategies for encouraging the availability of VC.[2] India being one of the most autarchic economies in the world, both the development of VC and the information technology industry have been intimately linked with the international economy.

A viable VC industry depends upon a continuing flow of investment opportunities capable of growing sufficiently rapidly until a time when they can give a reasonable return on investment. If such opportunities do not exist, then the emergence of VC industry is unlikely. Unlike the United States where the largest single source of funds for VC investments has been public and private sector pension funds, in India there are large pension funds but they are prohibited from investing in either equity or VC vehicles. From the present Indian economic environment it is evident that economic growth, asset creation and employment generation can be hastened only with availability of stable capital from investors having long-term commitment towards investing.

In the recent past, the focus of VC investors, desiring to make investments in India, has been skewed more towards high-growth sectors such as information technology. Till early 2001, a majority of investment by the VC sector went into the information technology sector. However, with the technology slowdown following the dot-com bust, venture capitalists have diversified their interest into other high-potential sectors such as pharmaceutical (particularly biotech), media and entertainment and business process outsourcing (IT-enabled services). Currently, many of the VC firms investing into India who earlier encouraged start-up companies, have evinced preference for expansion stage investments. Further, other than viable investment opportunities, venture capitalists are keen that any investment should have a visible exit horizon. To augment the exit options some venture capitalists prefer investing in listed entities, which offer more liquidity, Further, India still has constraints in terms of exchange controls. Therefore, structuring a VC fund and its downline investment in India becomes an intellectually challenging exercise.

Venture capitalists operating in India are subjected to considerable inaction and oversight by regulatory authorities. This paper discusses the regulatory and legal issues confronting Indian and offshore venture capitalists. It also describes in brief, the different sets of guidelines governing VC funds and companies in India issued by the Securities and Exchange Board of India (the SEBI), the Ministry of Finance and the Central Board of Direct Taxes (the CBDT), Finally, the business models by which this industry operates currently are also discussed.

2. WHAT IS VENTURE CAPITAL AND PRIVATE EQUITY?

At the outset it must be mentioned that the Indian regulations do not make a distinction between VC and private equity.

The typical man-in-the-street depiction of a venture capitalist is that of a wealthy financier who wants to fund start-up companies. The perception is that a person who develops a brand new change-the-world invention needs capital; thus, if they cannot get capital from a bank or from their own pockets, they enlist the help of a venture capitalist.[3]

In truth, venture capital firms are pools of capital, that invest in companies that represent the opportunity for a high rate of return within five to seven years. The venture capitalist may look at several hundred investment opportunities before investing in only a few selected companies with favourable investment opportunities. Far from being simply passive financiers, venture capitalists foster growth

1. The copyright of this article remains with Nishith Desai Associates.
2. Paper by Rafiq Dossani dated 4 April 2001, *Creating art Environment; Developing Venture Capital in India.*
3. www.nvca.org/def.htmlas accessed on 4 October 2002,

in companies through their involvement in the management, strategic marketing and planning of their investee companies. They are entrepreneurs first and financiers second.

Even individuals may be venture capitalists. In the early days of venture capital investment, in the 1950s and 1960s, individual investors were the archetypal venture investors. While this type of individual investment did not totally disappear, the modern venture firm emerged as the dominant venture investment vehicle. However, in the last few years, individuals have again become a potent and increasingly larger part of the early stage start-up venture life cycle. These "angel investors" will mentor a company and provide needed capital and expertise to help develop companies. Angel investors may either be wealthy people with management expertise or retired business men and women who seek the opportunity for first-hand business development.

A private equity investment on the other hand can be defined as an investment in a company with equity securities that are generally not publicly traded. Private equity firms focus on active private equity investments that enable them to acquire a large or controlling interest in a firm with solid growth potential. As a result, private equity firms can oversee, assist and, if necessary, redirect the company's activities or its management.

Historically, private equity funds have significantly outperformed public equities and mutual funds over the long term. That is because the active investor in a private equity investment can improve returns by, among other things, developing corporate strategies with management, implementing incentive programmes for management and employees, and identifying appropriate add-on acquisitions. Private equity funds do not generally make passive investments involving limited participation in a company's operation. In such cases, the investor has little or no influence on management's direction of the company. Naturally, the investment increases in value if the company prospers. However, the passive investor has no ability to exert influence if the company loses direction and may watch helplessly if the value of the investment is declining. Hence, private equity funds negotiate either a board seat or supermajority rights in the company in which they invest, which ensure that they have a significant say in the company.

3. GROWTH OF THE VENTURE CAPITAL INDUSTRY IN INDIA

Prior to the 1980s, the idea that VC might be established in India would have seemed Utopian. India's highly bureaucratized economy provided little institutional space for the development of VC. India, since the mid-1960s, had a strong mutual fund sector that began in 1964 with the formation of the Unit Trust of India (UTI), an open-ended mutual fund, promoted by a group of public sector financial institutions,' which eventually became the country's largest public equity owner and the.largest mutual fund operating in Asia.

With the high level of government involvement, it is not surprising that the first formal VC organizations began in the public sector in the year 1987.[4]

Thereafter, in November 1988, guidelines were issued by the (then) Controller of Capital Issues (CCI). These stipulated the framework for the establishment and operation of funds/companies that could avail of the fiscal benefits extended to them.[5]

In 1988, the Technical Development and Information Corporation of India (TDICI, now ICICI ventures) was set up, soon followed by Gujarat Venture Finance Limited. Both these organizations were promoted by financial institutions.[6]

In 1991, as part of a large number of financial reforms, the SEBI was created to regulate the stock market.

The formalization of the Indian VC community began in 1993 with the formation of the Indian Venture Capital Association (IVCA) headquartered in Bangalore. The prime mover for this was the TDICI.[7] The IVCA is the nodal centre for all venture activity in the country.

In 1996, the SEBI introduced guidelines, viz. SEBI (Venture Capital Funds) Regulations, 1996 (SEBI VCF Regulations), which VC funds have to adhere to, in order to carry out activities in India. The move liberated the industry from a number of bureaucratic hassles and paved the way for the entry of a number of foreign funds into India.

Thereafter, in 2000 the SEBI announced the SEBI (Foreign Venture Capital Investor) Regulations, 2000 enabling foreign VC and private equity investors to register with the SEBI and avail of certain benefits,

Industries have greatly benefited from the availability of VC assistance and it appears from statistics that the industry that has benefited the most from VC assistance in India is the computer industry and other related industries.

4. CRITICAL FACTORS FOR SUCCESS OF VENTURE CAPITAL INDUSTRY[8]

While making recommendations, the K.B. Chandrasekhar Committee which was constituted in 1999 by the SEBI to identify the impediments and suggest suitable measures to facilitate the growth of venture capital activity in India felt that the following factors are critical for the success of the VC industry in India:

- 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;

4. www.indiainfoline.com/bisc/veca/ch05.html accessed on 19 September 2002. The first origins of modern venture capital in India can be traced to the setting up of a Technology Development Fund (TDF) in the year 1987-88, through the levy of a cess on all technology import payments. The TDF was meant to provide financial assistance to innovative and high-risk technological pro grammes through the Industrial Development Bank of India.
5. Id.
6. Id.
7. See footnote 2.
8. Report of K.B, Cftandrasekhar Committee on Venture Capital,

- resource raising, investment, management and exit should be as simple and flexible as needed and driven by global trends;
- VC should become an institutionalized industry that protects investors and investee firms, operatirig in an environment suitable for raising the large amounts of risk capital needed and for spurring innovation through start-up firms in a wide range or high-growth areas;
- in view of increasing global integration and mobility of capital it is important that Indian VC funds as well as venture finance enterprises are able to have global exposure and investment opportunities; and
- infrastructure in the form of incubators, and research and development (R&D) needs to be promoted using government support and private management as has successfully been done by countries such as the United States, Israel and Taiwan, This is necessary for faster conversion of R&D and technological innovation into commercial products.

5, INVESTMENT AND INDUSTRY FOCUS

VCs may invest in certain focused sectors or may invest in any sector where growth opportunities are abound. Not all venture capitalists invest in "start-ups". While VC funds will invest in companies that are in their initial start-up modes, venture capitalists will also invest in companies at various stages of the business life cycle. A venture capitalist may invest before there is a real product or company organized (so called "seed investing"), or may provide capital to start up a company in its first or second stages of development known as "early stage investing." Also, the venture capitalist may provide needed financing to help a company grow beyond a critical mass to become more successful commonly known as "expansion stage financing" or "late stage financing".

The venture capitalist may invest in a company throughout the company's life cycle and therefore some funds focus on late stage investing by providing financing to help the company grow to a critical mass to attract public financing through a stock offering.

While high technology investment made up most of the venture investing in India at least till the dotcom bust, venture capitalists are now investing in companies such as construction, industrial products, business services, business process outsourcing, biotechnology, media, etc.

Venture capitalists eventually seek to exit the investment in three to seven years. An early-stage investment make take seven to ten years to mature, while a later-stage investment many only take a few years, so the appetite for the investment life cycle must be congruent with the investors' appetite for liquidity.

As per a recent study, investments by venture capitalists in various stages, country wise was found to be as shown in Table 1.

TABLE 1

Stage Wise[9] - Investments In Various Stages {%)

	Israel	India	United States	Hong Kong
seed start-up	9	5	10	5
early/first	19	41	11	27
later/second	27	18	32 6	2
expansion/third	36 9	36	25	43
turnaround/other		1	16	23

Source: IVCA, PWC, CVCA.

6. EXISTING REGULATORY FRAMEWORK FOR FOREIGN INVESTMENT

6.1. FDI Policy

Though the liberalization process in India began way back in 1991, it was only in the last five years or so during which foreign direct investment in India increased- This was fuelled by a series of reforms by the Indian government to further liberalize the Indian economy. The information technology boom, in which India emerged as a very strong player, was also responsible for increase in foreign investment into India.

The Foreign Direct Investment (FDI) Policy of India is formulated by the Secretariat of Industrial Assistance (SIA), which is a part of the Union Ministry of Commerce and Industry. In formulating the sector-specific FDI policy for various sectors, the SIA also takes into account the guidelines issued by the other ministries of the central government. The SIA was responsible for the formulation of the New Industrial Policy of India, which has also been amended from time to time, as further liberalization moves were announced by the government.

The Indian rupee is not yet fully convertible on the capital account and therefore, all transactions involving purchase or sale of any capital assets that involve persons who are not resident in India, are governed by India's exchange control laws. While the FDI Policy formulated by the SIA lays down the broad policy framework relating to foreign investments in India, the administration of the policy and its implementation are done through the exchange control laws. Earlier, the law which governed exchange control matters in India was the Foreign Exchange Regulation Act, 1973 (the FERA). This law was a rather draconian legislation that placed mammoth restrictions on foreign investment. In 1999, the FERA was replaced by a more moderate law called the Foreign Exchange Management Act, 1999 (FEMA). The FEMA confers powers on the Reserve Bank of India (RBI) to frame detailed Regulations in respect of various aspects of exchange control in a liberalized framework.[10] The RBI has accordingly announced a series of Regulations pertaining to various aspects of exchange control, including foreign invest-

9. www,vcline.com/invest.htm as accessed on 21 September 2002.
10. See Sec. 47 of the FEMA.

ments into India, These Regulations give legislative effect and force to the ;Policy formulated by the SIA.

The FEMA and the Regulations relating to FDI framed thereunder by the RBI[11] *(the* FDI Regulations) have from time to time been liberalizing the exchange control regime of India. Foreign investments in most sectors are now under what is known as the automatic route, which essentially means that an investor can bring in investment in those sectors without any prior approval from any regulatory authority. Some of the sectors continue to be regulated. Telecom services, for example, is one sector where foreign investment is permitted only up to 49%. Similarly, while FDI up to 100% is permissible under the automatic route for the IT sector and for B2B e-commerce, investment in B2C e-commerce is not eligible for the automatic route. Call centres is another segment where FDI up to 100% is permitted.

The FDI Regulations prescribe certain conditions to be met in order for a foreign investment to be eligible for the automatic route. Some of these significant conditions to be met are as follows:

- the investment should be by way of subscription to a fresh issue of shares and not by way of purchase of existing shares from existing shareholders of the com pany;
- the investment should be within the sectoral equity caps prescribed, where applicable. The sectoral caps are set out in Annexure II to Schedule I of ;the FDI Regulations;
- the investment should not be in sectors where indus trial licence is required to beobtained or where foreign investment has been expressly prohibited. Such sec tors have been specified in Schedule I of the FDI Reg ulations;
- the price at which the investment is made shall be in compliance with the formula prescribed under the FDI Regulations. The FDI Regulations prescribe a min imum price for foreign investment, which is arrived at on the basis of a prescribed formula;
- foreign investment cannot exceed 24% of the paid-up capital of a company involved in the small-scale sec tor;
- with the exception of the information technology sec tor, in all other sectors, the foreign investor cannot avail of the automatic route if such investor already has a previous venture or tie-up in India. However, this requirement applies essentially to strategic business investors and not to financial investors who may hold other portfolio investments in Indian companies.

In cases where any of the provisions of the FDI Regulations or the FDI Policy cannot be complied with, such an investment transaction would require the prior approval of the Foreign Investment Promotion Board (FIPB).[12] The FIPB normally takes between four to six weeks to clear proposals. As already mentioned; proposals for secondary purchase of existing shares are not eligible for automatic approval and therefore require the prior approval of the FIPB. Transfers of shares from an Indian resident to a nonresident require the approval of not just the FIPB but also the RBI.[13] Transfers of shares from a non-resident to an Indian require the approval of the RBI.[14] Transfers between two non-residents does not require any regulatory approvals from Indian authorities.[15]

6.2. VC regulations in India

Domestic and offshore VC funds investing in India are regulated by the SEBI. Until recently, the SEBI only regulated the domestic VC funds through the SEBI VCF Regulations. India did not have any mechanism to regulate or monitor foreign VC/private equity investors although regulations existed for domestic VC funds. While this put the domestic VC investors at a disadvantage especially after foreign investment in most sectors went through the automatic route, the Indian government felt the need to monitor (if not regulate) foreign investment in the VC sector. In order to address this, in September 2000, in addition to bringing in some major reforms to the existing SEBI VCF Regulations, which apply to VC funds based in India, the SEBI also introduced a new set of regulations applicable to offshore funds, called the SEBI (FVCI) Regulations, 2000 (the SEBI FVCI Regulations).

The legal framework within which VC funds would be required to operate are broadly covered within the ambit of the following regulations:

- SEBI (Foreign Venture Capital Investor) Regulations, 2000;
- SEBI (Venture Capital Funds) Regulations, 1996;
- SEBI (Disclosure & Investor Protection) Guidelines, 2000;
- Securities Contracts (Regulation) Act, 1956;
- Foreign Exchange Management (Transfer or Issue of Security by a Person Resident Outside India) Regula tions, 2000;
- SEBI (Substantial Acquisitions of Shares and Take over) Regulations, 1997; and
- Indian Income-tax Act, 1961.

6.2.1. The SEBI (Foreign Venture Capital Investor) Regulations, 2000

As mentioned .earlier, the SEBI FVCI Regulations merely monitor and do not regulate foreign investment in the VC sector nor make it mandatory for an offshore fund to register with the SEBI.

The term "foreign venture capital investor" (FVCI) has been defined under the SEBI FVCI Regulations to mean:

> an investor incorporated or established outside India, which proposes to make investments in venture capital fund(s) or venture capital undertakings in India and is registered under the FVCI Regulations.

The term "venture capital undertaking" (VCU) has been defined as follows:

> "venture capital undertaking"[16] means a domestic company:
> (i) whose shares are not listed in a recognised stock exchange in India;

11. The Foreign Exchange Management (Transfer or Issue of Security by a Person Resident Outside India) Regulations, 2000.
12. Regulation 10 of the FDI Regulations.
13. Regulation 9 of the FDI Regulations.
14. Id.
15. Id.
16. Sec. 2 (n) ofyhe SEBI VCF Regulations.

(ii) which is engaged in the business of providing services, production or manufacture of articles or things, but does not include such activities or sectors which are specified in the negative list by the Board, with approval of Central Government, by notification in the Official Gazette in this behalf.

From the definition it is clear that VCUs are only those domestic unlisted companies engaged in the business of providing services, production or manufacture of articles or things.

Eligibility criteria

In order to determine the eligibility of an applicant, the SEBI would consider, inter alia, the applicant's track record, professional competence, financial soundness, experience, whether the applicant is regulated by an appropriate foreign regulatory authority or is an income tax payer or submits a certificate from its banker of its or its promoter's track record where the applicant is neither a regulated entity nor an income tax payer. The applicant can be a pension fund, mutual fund, investment trust, investment company, investment partnership, asset management company, endowment fund, university fund, charitable institution or any other investment vehicle incorporated and established outside India.

Investment conditions and restrictions

All investments to be made by an FVCI would be subject to the following conditions:

- FVCIs are permitted to invest only in VCUs. A VCU has been defined to mean domestic companies which are not engaged in activities which have been classi fied under the negative list of the SEBI FVCI Regula tions, which broadly includes undertakings engaged in real estate business, non-banking financial services, gold financing, etc. and whose shares are not listed on a recognized stock exchange.

- While FVCIs are permitted to invest their entire cor pus in a domestic SEBI VCF (defined later), they can not invest more than 25% of the funds committed for investments in India in one VCU.

- An FVCI can make investments in VCUs subject to the following restrictions:
  - at least 75% of the funds committed to India has to be invested in unlisted equity shares or equity-linked instruments;
  - not more than 25% of the funds committed to India can be invested by way of:
    - subscription to the initial public offer of a VCU whose shares are proposed to be listed subject to a lock-in period of one year;
    - debt or debt instrument of a VCU in which the VCF (defined later) has already made an investment by way of equity.

An FVCI is required to appoint a.domestic custodian and will have to enter into an arrangement with:a designated bank for the purpose of opening a special non-resident Indian rupee or foreign currency account. The SEBI acts as a nodal agency for all necessary approvals including the permission of the RBI for the opening of the bank account. In addition to the above investment conditions and restrictions, there are certain reporting and disclosure requirements that need to be satisfied by a registered FVCI on a continuing basis.

Benefits of registration with the SEBI

Though it is not mandatory for an offshore fund to register with the SEBI as an FVCI, the SEBI and the RBI have extended certain benefits to funds registered under the FVCI Regulations making it beneficial to register. FVCIs registered with the SEBI would be entitled to the following benefits:

~ The FVCIs would be eligible to freely remit monies into India for making investments in a VCU. Any fresh issue of shares by an Indian company in most sectors has been made automatic under the Foreign Exchange Management (Transfer or Issue of Security by a Person Resident Outside India) Regulations, 2000 (FDI Regulations). Therefore, any purchase of shares of an Indian company by a non-resident from a resident requires to be approved by the Foreign Investment Promotion Board -(FIPB) and the RBI. Such approval is granted on a case-by-case basis and generally takes approximately four to eight weeks. However, as an FVCI, no prior approval of the FIPB or the RBI is needed for making investments into Indian VCUs.

- Generally, on the purchase of shares of an unlisted company by a non-resident, the minimum price to be paid would be linked to the net asset value of the shares. Similarly, for exits involving transfer from a non-resident to a resident, the exit price is capped at the price of the shares on the stock exchange (listed company) or to the net asset value (unlisted company). However, a special exemption has been carved out for FVCI's in as much that an FVCI may acquire or sell its Indian shares/convertible debentures/units or any other investment at a price that is mutually acceptable to both parties.[17] Thus, there are no entry or exit pri cing restrictions applicable to an FVCI. This could be a very significant benefit for FVCIs, especially in the case of a strategic sale or buy-back arrangement with the promoters at the time of exit from unlisted com panies.

- The transfer of shares from FVCIs to promoters is exempted from the public offer provisions under the SEBI (Substantial Acquisitions of Shares and Take over) Regulations, 1997 (Takeover Code), if the port folio company gets listed on a stock exchange post the investment, This ensures that if the promoters have to buy back the shares from the FVCIs, they will not be burdened with the public offer requirement which would otherwise require an offer to the other share holders of the company to buy up to 20% of the paid-up capital of the company.

17 Reserve Bank of India; Notification No. FBMA 32/200Q-RB dated 26 December 2000.

- FVCIs registered with the SEBI have been accorded the status of Qualified Institutional Buyer (QIB) and are accordingly eligible to subscribe to the securities at the initial public offering of a VCU through the book-building route.
- Under the SEBI (Disclosure and Investor Protection) Guidelines, 2000;(SEBIiDIP Guidelines), the pre-issue share capital of a company, which is in the process of an IPO, is locked ins for a period of one year from the date of allotment However, an exemption has been granted to VC funds registered under the SEBI VCF Regulations and SEBI FVCI Regulations. This would facilitate the FVCIto exit from their investments post-listing. However^ in the case of securities subscribed to in an initial public offering (IPO), there would be a lock-in of one year applicable to such investments.
- The terms "promoter" and "promoter group" have been broadly defined under the SEBI DIP Guidelines to include any person who plays an instrumental role in the decisions ,of a company making a public offer. A private equity investor, generally reserves certain veto rights in the company and in most cases is actively involved in the decisions of the company. If the private equity is not registered as an FVCI, it could be treated as a part of the promoter group, thereby subjecting it to certain onerous requirements that are applicable to promoters. The SEBI has clarified that an SEBI-registered venture capital fund or an FVCI, would generally not be treated as promoters for the purpose of the above guidelines.
- The SEBI is also considering a proposal to create a separate trading window on the Over The Counter Stock Exchange of India (OTCEI) for QIBs to trade in unlisted securities. However, this proposal is yet to be adopted formally.

6.2.2. The SEB! (Venture **Capital Funds)** Regulations, **1996**

In December 1996, the SEBI notified the SEBI VCF Regulations. These regulations were further amended significantly on 15 September 2000 through the SEBI Venture Capital Funds (Amendment) Regulations, 2000. Indian Venture Capital Funds (VCFs), whether existing or newly organized, who wish to avail of the tax benefits available to venture capital funds, must register with the SEBI and comply with the provisions of the VCF Regulations.

Under the SEBI VCF Regulations, a domestic venture capital fund can be organized either in the form of a trust or as a company. Though the guidelines do not appear to make registration with file SEBI mandatory, the SEBI has made its intention clear to regulate all domestic VCFs.

Before discussing the provisions of the aforesaid regulations we have hereinbelow discussed a few of the important definitions:

It is important to note the definitions of certain terms like, Venture Capital Fund (VCF), Venture Capital Company (VCC) and Venture Capital Undertaking (VCU), as defined by the SEBI VCF Regulations. There are certain provisions in the Indian Income-tax Act, 1961 (ITA) that provide tax incentives for investments by VCCs/VCFs in Indian unlisted companies.

- VCF

  VCF[18] means a Fund established in the form of a trust or a company including a body corporate and registered under SEBI VCF Regulations which-
  (i) has a dedicated pool of capital;
  (il) was raised in the manner specified under the SEBI VCF Regulations; and (Hi) invests in venture capital undertaking in accordance with the SEBI VCF Regulations.

  The trust deed under which the trust is settled must be registered under the provisions of the Registration Act, 1908 (16 of 1908), VCFs may be set up either as trusts (funds) or as companies. In India, the governing law relating to trusts is the Indian Trusts Act, 1882. The SEBI VCF Regulations make it clear that a trust must be documented as well as registered.

- VCC

  The term VCC[19] means a company incorporated under the Indian Companies Act, 1956 (I of 1956).

Investment conditions and restrictions

In addition to the investment restrictions and conditions applicable to FVCIs, the following conditions would apply to a VCF:

- minimum investment to be accepted from any investor should be INR 500,000 (approximately USD 11,500) except in the case of employees, principal officers or directors of the VCF, employees of the manager of the VCF where lower amounts may be accepted;
- minimum capital commitments from its investors should be INR 50 million (approximately USD 10 mil lion);
- a VCF is not permitted to invest in associate com panies. An "associate company" is defined to mean a company in which a director or trustee or sponsor or settlor of the VCF or the investment manager holds, either individually or collectively, equity shares in excess of 15% of its paid-up equity share capital of VCU;[20]
- the subscription/contribution agreement and/or a placement memorandum detailing the strategy for investments, risk factors, taxability of investors should also be issued prior to raising commitments;
- the SEBI VCF Regulations restrict VCFs from listing their securities for a period of three years from the date of their issue.

Further, a VC fund registered under the SEBI VCF Regulations will be subject to investigation/inspection of its affairs by an officer appointed by the SEBI and in certain circumstances the SEBI has the power to direct the VCF to divest the assets of the VCF, to stop the launching of any new schemes, to restrain from disposing any assets of the VCF, to refund monies of investors to the VCF and also to stop operating in, assessing the, capital market for a specified period.

18, Sec. 2 (m) of the SEBI VCF Regulations,
19. Sec. 2 <c) of the SEBI VCF Regulations.
20. Regulation^ (aa), SEBI VCF Regulations.

Indian Income-tax Act, 1961

VCFs registered with the SEBI are accorded a "pass through" status for tax purposes. Sec. 10(23FB) of the ITA provides that any income of a VCF set up to raise funds for investments in VCUs, will be tax exempt in India, Such exemption is available provided the VCF is registered with the SEBI under the SEBI VCF Regulations and complies with the conditions laid down in the SEBI VCF Regulations. Such VC funds will be tax exempt in India in respect of any income arising out of investments made in unlisted Indian portfolio companies. Thus it can be seen that the income tax exemption is only available to domestic funds, which invest in unlisted Indian portfolio companies. Further, Explanation 2 to Sec. 10(23FB) of the ITA provides that the income of a VCF/VCU shall continue to be exempt if a company subsequent to the VC investment gets listed on a stock exchange.

Further, as per the provisions of Sec. llSUof the ITA, the VCF/VCU will not be required to withhold any tax in India on the income distributed by it to the investors. As per the provisions of Sec. 115U of the ITA, any income distributed by the VCF/VCU will be chargeable to tax in the hands of the investors in the same manner as if it were the income of the investors, had they made such investments directly in the Indian portfolio companies.

7. TAX STRUCTURING OF FOREIGN INVESTMENTS

India taxes Indian-source income as well as the foreign-source income of its residents, subject to tax treaty and other reliefs. The foreign-source income of non-residents or individual persons not ordinarily resident in India is only taxed if received in India. In certain circumstances, income arising outside India may be deemed Indian-source income.

Taxable income is ascertained according to the rules for the particular class of income and then aggregated to determine total taxable income. Tax changes are introduced by annual Finance Acts preceded by the "Budget" statement, usually in February. The "previous year" basis of assessment is used.

The tax rates (as proposed by the Finance Act, 2002) applicable to residents as well as non-residents in respect of the various types of income earned in India have been summarized in Table 2:

TABLE 2

(%)

Category	Status	Capital gains				Dividends
		Long term*		Short term		
		Listed	Uri-listed	Listed	Un listed	
individual	resident	10.5	21	31.5	31.5	31.5
	non-resident	10'.5	21	31.5	31.5	21
corporate	resident	10,5	21	36.75	36.75	36.75
	non-resident	10.5	21	42	42	21

- Long.term means where securities have been held for more than 12 months.

The above tax rates may be reduced under the double taxation avoidance treaty (tax treaty) between India and the foreign country in which the investors are residing.

Structuring of investment into India is extremely important. It is important for foreign investors to invest in India from a country with which India has a tax treaty as this would avoid the potential double taxation of income both in India as well as the home country. In the event that the home country of the investor does not have a tax treaty with India, it is important to structure the investment through a tax-favourable jurisdiction. However, such structuring can be done only in the event there is sound commercial justification for investing through a tax-favourable jurisdiction.

India has developed a large network of treaties world over. Each of these treaties provide for different terms for taxing the income arising in India. While some treaties provide for lower withholding tax on interest, some provide for, concession on dividend withholding tax and some on capital gains. Hence, choosing a jurisdiction which provides for maximum benefits is important. While identifying a jurisdiction for locating the holding company, some of the important factors that one should consider are:

- Whether it has a good tax treaty with India?
- Whether the local laws provide for flexibility in terms of choice of entities?
- What are the local taxes?
- Whether the corporate laws allow enough flexibility for repatriation of capital?
- Whether there are any exchange controls which may affect repatriation of income? ,

Depending on the nature of income and the Indian operations, various jurisdictions like the United Arab Emirates, Cyprus, Mauritius, the Netherlands, etc. have been used as holding company jurisdictions for investing into India. However, over the years, Mauritius has emerged as the most favourable jurisdiction for investing into India because of the favourable tax treaty that India has entered into with Mauritius and Mauritius has in fact become one of the largest investors into India. The India-Mauritius tax treaty provides for favourable tax treatment in respect of dividends and capital gains. Under the treaty, capital gains earned on divestment of shares are taxable only in the country of residence. Thus a Mauritius resident entity which divests shares held in an Indian company is subject to capital gains tax only in Mauritius and is exempt from tax in India. Further, Mauritius does not impose any capital gains tax and hence if structured properly the investor would be taxed directly in his home jurisdiction. Also, dividend earned by a Mauritius entity attracts a lower withholding tax of 15% or *5%* in India as against the normal 20% depending on its percentage holding in an Indian company.

In addition to tax benefits, from exchange control perspective also an intermediate holding company for investment into India is useful. India has exchange controls and there are restrictions on repatriation of capital. Structuring of investments through an intermediate holding company provides the necessary Oexibility in terms of restructuring or divestment since all these can be carried out at the intermediary level.

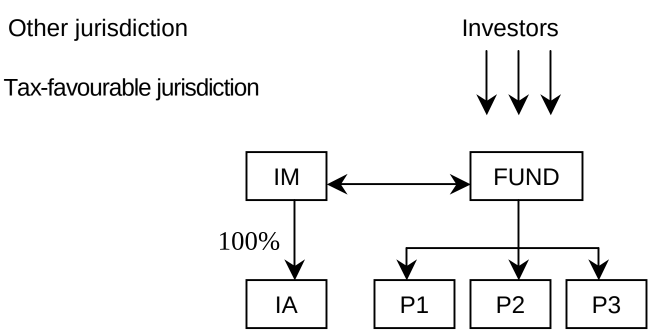
Based on the above, It has become more of a "rule of thumb" to have a Mauritius entity between the investor jurisdiction and Indian investee company. However, a word of caution is not misplaced at this stage. It is crucial that in order to enjoy capital gains tax exemption under the India-Mauritius tax treaty, 'one should ensure that the Mauritius entity does hot have a permanent establishment (PE) in India.

If the intention is to set up a VCF for investment into India, structuring becomes even more crucial as any additional tax on account of non-availability of tax treaty benefits could adversely affect the returns to the investor. The two most commonly used structures for offshore funds are as follows:

7.1. Offshore structure

Under this structure an investment vehicle (Fund), which could be an ordinary company, an LLC or an LP is organized in a tax-favourable jurisdiction outside India, which will pool investments from investors. The Fund will then make investments directly into Indian portfolio companies. There would generally be an offshore investment manager (IM) for managing the assets of the fund and an investment advisor (IA) in India for identifying deals and to carry out preliminary due diligence on prospective investment opportunities. The IA could be a 100% subsidiary of the IM. The structure can be diagrammatically represented as shown in Figure 1.

FIGURE 1

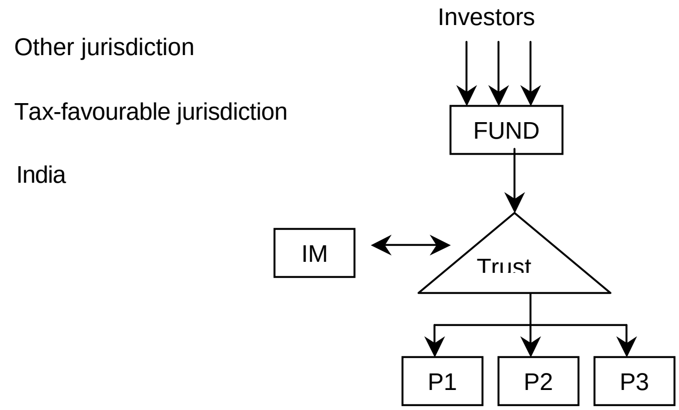


It is important that the Fund, the IM, the IA and their operations are structured extremely carefully so as to minimize the risk of the Fund having a PE in India. The Fund could be registered with the SEBI as an FVCI under the appropriate regulations so that it can avail of the exchange control benefits in India.

7.2. Unified structure

This structure is generally used where domestic (i.e. Indian) investors are expected to participate in the fund. Under this 'structure, a trust or a company is organized in India. The domestic investors would directly contribute to the trust whereas overseas investors pool their investments in an offshore vehicle and this offshore vehicle invests in the domestic trust. The portfolio investments are made by the trust, which is registered with the SEBI as a VCF. The trust would generally have a domestic manager or an adviser. The offshore fund may also have its own offshore manager/adviser. The structure is depicted in Figure 2.

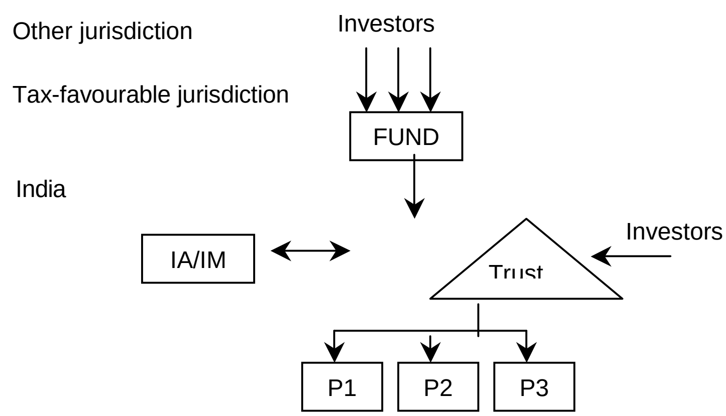
FIGURE 2



7.3. Co-investment structure

Another variant to the unified structure could be where the Fund, instead of investing through the domestic trust can invest in portfolio companies simultaneously with the trust. In that case, the structure would look as shown in Figure 3.

FIGURE 3



In this structure, the offshore as well as domestic investors co-invest in the portfolio companies. While the domestic Trust is registered with the SEBI as a VCF, the offshore Fund may or may not be registered as an FVCI. The returns to the investors will havfe to be appropriately linked, so as to avoid any mismatch on account of exchange rate fluctuations and possible exit price disparity for the foreign and domestic investors. The IM could act as an investment advisor for the foreign Fund.

There are no tax incentives available for die management fees or carried interest earned by the IA/IM in India. However, the tax incidence can be minimized by careful structuring of the carried interest pay-out from die fund.

8. IMPEDIMENTS TO THE VC INDUSTRY

Though the regulators have done a laudable job in regulating the industry in a manner such that the industry .contributes to the economic growth of the country, it is not surprising that its regulations do have certain impediments that could stagnate the optimum growth of the industry, due to the industry being comparatively new. Impediments to the development of the VC industry in India can be traced to India's corporate, tax, and currency laws. We will briefly discuss below the shortfalls of the existing regulations:

- India's corporate law does not provide for limited part nerships, limited liability partnerships, or limited lia bility corporations (LP, LLP, and LLC, respectively);
- moreover, corporate law allows equity investors to receive payment only in the form of dividends (i.e. no in-kind or capital distributions are allowed);
- further, the SEBI VCF Regulations do not permit a registered VC fund to invest its shares in companies that are listed on a stock exchange, which is a major detriment where the investors are desirous of a visible exit opportunity;
- further, the SEBI VCF Regulations do not permit a registered VC fund to invest in foreign securities;
- the taxation law is disadvantageous from the view point of the foreign venture capital investor. Income of a foreign venture capital investor is taxed in India, as opposed to a domestic VC fund registered under the SEBI VCF Regulations. This is a big detriment for such foreign investors as most often they are tax exempt in their country of origin;
- another significant impediment to the development of a vibrant VC industry is India's foreign currency regu lations;
- further, VC funds registered under the SEBI VCF Regulations are not permitted to invest abroad. The In dian legal and regulatory environment continues to in hibit VC investors from maximizing their returns. '

9. JUDICIAL OUTLOOK

In order to structure a fund through a tax-favourable jurisdiction (under both the above options) and in order to be eligible to avail the benefit under the double taxation avoidance agreement entered into by India, careful structuring is extremely crucial. There have been instances in the past where especially the use of Mauritius as a holding jurisdiction for investing into India has been looked upon unfavourably by the Indian tax authorities. In the case of NatWest, the Authority for Advance Rulings (AAR) had denied a ruling on the grounds that the use of Mauritius was merely for tax avoidance. The AAR in this case refused to grant a ruling in respect of a transaction that was prima facie designed to avoid tax. The AAR is not empowered to issue rulings on tax planning techniques under its domestic taxation laws. At this point it must be noted that advance rulings in India are private in nature and are binding only on the applicant and the income tax authorities, though they do have some amount of persuasive value.

However, careful structuring of an investment can reduce the risk of denial of tax treaty benefits. There has been a ruling in the case of AIG[21] followed by DLJ, wherein the AAR granted the benefits of the India-Mauritius tax treaty and observed that if there was a commercial justification for setting up a special purpose vehicle in Mauritius, the benefits under the India-Mauritius tax treaty should be made available. In addition to the commercial justification, it is also important to ensure that the structure does not expose the entity to a possibility of a PE in India. Generally under a tax treaty, if the entity is held to have a PE in India, the income attributable to such PE would be subject to tax in India. There is a fair amount of subjectivity involved in the determination of a PE and hence very careful thought has to be given while finalizing a structure, especially the management of the Fund.

In one of the recent rulings reported in (2001) 116 Taxman 719, the AAR held that gains realized on the divestment of shares in India, by a Mauritius-based private equity fund, are business profits. The AAR stated that the private equity fund was a resident of Mauritius and thus was eligible for the tax benefits under the treaty. According to the AAR, private equity funds constitute a business of buying and selling shares, and therefore gains arising on sale of shares should be taxed as business profits, and not as capital gains.

The AAR considered the aspects of a private equity fund structure and ruled that neither the investment adviser in India, nor its custodian, constituted a permanent establishment in India of the Mauritius-based fund. In the absence of a PE, the entire business profits were only taxable in Mauritius. This ruling essentially means that even if the fund was not established in Mauritius but in any other country having a tax treaty with India, so long as the fund does not have a permanent establishment or a business connection in India, the income earned by the fund should not be subjected to tax in India.

Here it is pertinent to point out to the readers that recently in May 2002, the Delhi High Court has delivered a combined ruling on two public interest litigations (PILs). The PILs challenged the Circular,[22] which provided for a clarification on the availability and application of the India-Mauritius tax treaty. In the PILs, the petitioners contended that India was losing out on tax revenues, which it would have otherwise collected had FIIs invested into the Indian capital markets directly and not via Mauritius-based entities. The Delhi High Court quashed the Circular and obiter observed the ill effects of treaty shopping on the Indian economy. The Indian government has appealed against this order before the apex court of India by filing a special leave to petition.

10. STRUCTURING THE INSTRUMENT

Having gone through the initial stages of due diligence and negotiations, and after having addressed the entry level exchange control issues, the next concern an investor is

21, Reported in [1996] 224ITR 473 (AAR).
22. Circular No. 789 issued by the CBDT dated 13 April 2000.

likely to look at it is what kind of instrument it should get against its investment and what level of protections, and risks, the various kinds of instruments would offer to foreign investors. While this may be more relevant in a private equity context, it could be equally relevant in certain strategic investments.

The simplest and perhaps the most obvious instrument that an investor can get to evidence the investment would be the equity share. However, for several reasons, an investor may wish to hold a part or whole of its investment in the form of some other instrument. Some of the usual reasons in an Indian context why a foreign investor would prefer an instrument other than equity shares are outlined below:

- the investor may wish to get a preference on dividend or liquidation or both;
- as discussed earlier, prevailing Indian exchange con trol laws do not permit foreign equity investment beyond a certain level in certain sectors. Therefore, the investor might want to structure an instrument, which does not violate Indian exchange control laws. This is a roadblock investors very often face particularly in the telecom sector in India, as this is a very popular sector for investors and yet foreign equity beyond 49% is not permitted;
- certain tax holiday provisions under the ITA provide for immediate loss of the tax holiday if the shareholding or beneficial ownership of the company changes in any year beyond a specified percentage. Therefore, the investor may not wish to jeopardize this tax holi day for its investee company by subscribing to equity shares;
- the investor may wish to get disproportionate voting rights on its investment in return for the strategic value such investor may bring;
- Indian corporate and securities laws may place certain restrictions with respect to equity shares, which may not suit the commercial understanding between the parties;
- the investor may seek liquidity in overseas markets and the maximum flexibility in terms of exit options.

Due to the above reasons, the following alternate instruments are usually resorted to by investors in Indian companies who are confronted with any of the above issues. The instrument chosen is based on the considerations that matter most to the investor and therefore, the transaction has to be viewed holistically before determining which alternate instrument suits the needs of an investor the best.

10.1. Instruments denominated in Indian rupees

10.1.1. Convertible preference **shares**

Under Indian company law, a preference share by definition gets a preference over the other shareholders as to dividend and as to recovery of capital in the event of a liquidation, A convertible preference share is a preference share that gets converted to equity shares based on a specified conversion ratio, upon maturity. Till the time of conversion, the shareholder would continue to get dividend at a specified rate. However, a convertible preference share will carry no voting rights till the time of conversion, except in very limited circumstances. This would be a good instrument for overcoming difficulties dictated by tax holiday issues, as there would be no change in beneficial interest of a company by issuing convertible preference shares. However, this would not address the difficulties that exchange control sectoral caps may place, as convertible preference shares are treated the same as equity shares for the purpose of reckoning sectoral investment caps. Further, die RBI has prescribed that the dividend payable on convertible preference shares issued to non-resident parties cannot be in excess of 300 basis points over the Prime Lending Rate of the State Bank of India,

10.1.2. Convertible debentures

Debentures are basically debt instruments. In the case of a convertible debenture, the debenture holder would receive interest from the company till the maturity date, after which the debentures would be converted into equity shares ranking on par with the other equity shares of the company. Convertible debentures too are treated the same as equity shares for the purpose of reckoning sectoral caps, and this instrument would therefore not be very helpful in the event of difficulties posed by sectoral caps.

10.1.3. Warrants

Warrants are basically convertible instruments that can be converted into equity shares at the convenience of the holder, by paying a conversion price. A warrant is basically a right to subscribe to equity shares at a later stage. Warrants that have been issued and are outstanding are not counted for the purpose of reckoning sectoral investment caps. It is for this reason that warrants are often used as stopgap instruments by foreign investors to ensure that they do not exceed the sectoral caps, but at the same time retaining the right to acquire the shares underlying the warrants within a specified time frame, in the hope that the regulatory regime might change in the future, whereby the sectoral caps may either be done away with or enhanced. While this instrument may seem like a very effective way of overcoming the difficulties posed by the sectoral investment caps, it has its own limitations, Firstly, as a warrant is only a right to subscribe to shares at a later date, the investor would not get any of the rights attaching to shares (including dividend, voting rights etc.). Therefore, this instrument makes sense only when used as a stopgap arrangement, with the investor's economic rights being compensated in other contractual arrangements with the company. Another problem with warrants could be that in the event the sectoral caps remain in place at the time when the company goes in for an initial public offering (IPO), then the investor would effectively have to forfeit the shares underlying the warrants. This is because a company that plans to do an IPO is required, under the securities laws of India, to convert all outstanding convertible securities, including warrants and options, into equity shares before doing the TPO.[24] Alternatively, if the company cannot convert them into equity shares for any reason, including any legal restrictions, the company would

23. Sees. 10A and 10B of the Income-tax Act, 1961.
24, Under the DIP Guidelines, all convertible instruments that are outstanding have to be either converted or cancelled prior to the IPO.

have to cancel all such outstanding-convertible securities before'the IPO. Therefore, warrants could pose an element of risk as to the investment of the foreign investor in this context.

In 2000, the Indian Companies Act, 1956 was amended to introduce Sec. 605-A, thereby permitting foreign companies to make a public offer of Indian Depository Receipts (IDRs). The Department of Company Affairs, Government of India (DCA) as per press reports" is in the process of preparing the Companies (Issue of IDRs) Rules, 2002.

10.2. Instruments denominated in foreign currency

The reason a foreign investor would wish to receive an instrument denominated in foreign currency is to get liquidity in an international market. Therefore, apart from being denominated in an internationally accepted currency, the instrument also has to be a universally recognized one. The two most commonly recognized foreign currency denominated securities that can be issued by Indian companies are global depository receipts (GDRs)/ American depository receipts (ADRs) and foreign currency convertible bonds (FCCBs).

10.2.1, ADRs/GDRs

ADRs and GDRs are treated as foreign securities issued by an Indian company and these instruments are founded on underlying equity shares. The underlying shares are denominated in Indian rupees while the ADRs and GDRs are usually denominated in dollars. Foreign investors in Indian companies who seek to have their investment evidenced by a dollar-denominated instrument can therefore seek to have ADRs/GDRs issued to the^rn by the company by way of private placement. This would mean that they would hold ADRs/GDRs that are not registered with the regulators or stock exchanges outside India. The holders of ADRs/GDRs can sell these instruments privately outside India or they could convert these instruments into the underlying equity shares at any point of time. In the event that the Indian company subsequently goes in for a publicly listed ADR/GDR offering in the United States or such other market outside India, the investor could seek concurrent registration of the ADRs/GDRs held by it, This right would typically be provided for upfront in the investment transaction documentation.

10.2.2. FCCBs

FCCBs are basically considered as external commercial borrowings of the Indian company. They provide for an interest return to the investor for a specified maturity period at the end of which they can be converted into equity shares of the issuing company. FCCBs would, in principle, provide essentially the same kind of comfort to the investor, i.e. liquidity in international markets. However, it may be mentioned that FCCBs are not as popular or commonly accepted internationally as are ADRs and GDRs. This is one reason why companies seeking to raise money through equity expansion prefer the ADR/GDR route to the FCCB route.

11. LEGAL DOCUMENTATION

The basic documents that are required for carrying on the activities of a VC fund and are required by the SEBI Regulations are as follows:

Trust deed

A trust deed is the document by which the settlor of a trust settles the trust by entering into an indenture of trust with the trustee. This document is required only when the VCF is set up in the form of a trust, and contains such particulars as to the management of the trust fund, the powers of the trustee, etc*

Investment management agreement

This is an agreement entered into between the investment manager and either the trustee of a VCF set up as a trust or director of a VCC to manage the assets of the trust. Specific terms which are included in this agreement are the management fees payable annually for managing the fund and carried interest. This is most often negotiated with investors upon formation of the fund in the terms and conditions of the investment. The management fee is generally about 2% of the capital commitment. Another important consideration for the investment manager is his carried interest component which connotes the profit split of divestment proceeds to the investment manager. This is the investment manager's fee for carrying the management responsibility plus all the liability and for providing the needed expertise to successfully manage the investment. Carried interest generally is about 20%.

Contribution agreement

This is an agreement entered into between the investors to a VCF set up in the form of a trust and the trustee of the trust or the investment manager appointed by the trustee to manage the affairs of the trust as the case may be on the making of capital commitment to the trust.

Subscription agreement

This is an agreement entered into between the investors to a VCC and the VCC or the investment manager appointed by the VCC to manage the affairs of the VCC as the case may be on the making of capital commitment to the VCC.

Memorandum and article of association of the VCC

These are the charter documents of a VCC, which state the objects of the company and the rules that govern the administration of the company.

Apart from the above documents a private placement memorandum is prepared which is used as a marketing tool of the fund.

12. CONCLUSION

India today is the second most preferred investment destination in Asia after China and given that it has certain

25, *The Economic Times*, Mumbai Edition and *the Business Standard*, Mumbai Edition, 1 October 2002.

very significant advantages over China, like proficiency in English, a well-developed common law system, a democratic government, a pool of talented managerial personnel, India does hold the pr^n^se of becoming the "Number One" investment destination iiri.Asia. However, in order to do so, the Indian government needs to constantly review its policies so as to nutyu^e more foreign investment.

All said and done, India still remains a difficult environment for venture capitalists. Even today the Indian investment environment is 'highly regulated. An Indian venture capital industry is emerging, but it may not thrive in the current investment environment. While trying to control the venture capital industry, the Indian government has provided various incentives for the VC industry. However, it is disappointing that the Indian government is trying to regulate the VC industry though in most countries this industry is mostly unregulated. It is time for more deregulation to attract foreign VCs as well as to encourage domestic VCs. After the dotcom bust, there has been a shift from investments in information technology to investments in the ITES sector (information technology enabled services) and also in BPO (business process outsourcing) operations.

However, despite the regulatory environment, it is encouraging to note that venture capital investment in India is expected to grow 20% to around USD 1.1 billion as projected by the IVCA.[26]

26. "VC inflows to rise 20%", *The Economic Times* dated 28 September 2002.