Foreign Venture Capital Investment: The Indian Experience

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Venture capital investment has become one of the most rapidly growing investment modes in India. The contributing factors to this growth are the recent economic and legal changes. The Indian government has provided operational and functional autonomy to institutions while at the same time closely monitoring them. Though there are several rules and regulations that lay down various procedures for the investment, the law is still investment-friendly and offers various benefits. Some tax reforms have also been introduced that are both sound and practical for both foreign and domestic investors. This paper introduces the reader to not only the positive aspect of the system but also to the weaknesses it still has to overcome. This paper also suggests that a venture capital investment manual for domestic and foreign venture capitalists may make the investment market grow faster and make the investment decisions easier.

I. Introduction

Venture capital is a term used for capital that is invested by an outsider in a small or struggling business venture. Usually the venture is a high risk business, but, at the same time, the expected returns are high as well. In a typical venture capital investment, a venture capitalist would invest in a business over a period of three to five years and exit once it has earned its return. But the growth and smooth functioning of the venture capital market depends on the total growth and smooth functioning of the country's legal system and economy.[1] Therefore, to understand the venture capital market development in India, or any country for that matter, it is necessary to take a look at the legal system and the economy first.

This paper is divided in six parts. The first part describes the background of the Indian legal system and its economy, including the economic reforms introduced since the early 1990s that contributed to a rapid growth. Although many changes have been introduced to improve the overall economic environment, it is important to highlight the fact that

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1. *See* Richard Sylla, *Venture Capital in Financial Systems: Historical and Modern Perspectives*, *in* NEW VENTURE INVESTMENT: CHOICES AND CONSEQUENCES 153 (Ari Ginsberg & Iftekhar Hasan eds., 2003).

there are still many areas that demand attention. The second part of the paper explores the major modes of investment in India, including venture capital. The third part discusses the development of venture capital investment, in particular, and the market conditions in which venture capital investment is flourishing in India. The regulation and taxation of venture capital is discussed in the fourth and fifth parts, respectively. The last part briefly explains the exit policy of India.

II. The Legal System and the Economy of India

A. The Common Law System Based on Rule of Law

India was a British colony for almost two centuries, and over this period of time, the British established their own common law system in India.[2] Even after obtaining independence in August 1947, India decided to follow the common law system and retain the British education system.[3] India is a socialist democratic republic, with governments at the central and state levels. India is the largest democracy in the world and has been successful in providing political, social, economic, and cultural freedom to its citizens.[4] It is a country where the rule of law prevails and people have the assurance they would be ruled by law and not by whims. The legal system has all that is needed for the rule of law to thrive, namely clear and consistent rules, fair and reasonable laws that are acceptable to most, and an independent judiciary.[5] Despite a sound legal system and established democracy, the Indian economy has been struggling to grow. As Sen stated, "[i]nsofar as democracy is its own reward, it would be a mistake to treat Indian democracy as a failure on the simple ground that it has not helped generate a high rate of economic growth."[6] There have been various contributory factors to the slow growth of the economy, which are discussed later. But it would not be an exaggeration to say that the Indian economy has been progressing well for the past two decades.

B. Economic Structure

India is the fourth largest and one of the fastest growing economies in the world.[7] After independence, the socialization of the economy, and banking in particular, reinforced the strength of the stock markets as a source of capital. "[B]y the 1960s, India had one of the most sophisticated stock markets in any developing country."[8] But since 1991, India's economy has undergone major reforms. These reforms involved certain fundamental changes to the existing set-up, one being the privatization of markets with less state inter-

2. *See* M.P. Jain, Outlines of Indian Legal History (5th ed. 1990).

3. The English language is usually given priority over any other language in schools and at the university level.

4. *See generally* India Const. (Part III of the Constitution of India protects six major fundamental rights of the citizens).

5. *See* Ross P. Buckley, *The Role of the Rule of Law in the Regulation of Global Capital Flows*, *in* Globalisation and the Rule of Law 140 (Spencer Zifcak ed. 2005).

6. Amartya Sen, *Democracy and Secularism in India*, *in* India's Emerging Economy: Performance and Prospects in the 1990s and Beyond 35, 37 (Kaushik Basu ed. 2004).

7. *See* Gurcharan Das, *The India Model*, Foreign Aff. July-Aug. 2006, at 2.

8. Rafiq Dossani & Martin Kenney, *Creating an Environment: Developing Venture Capital in India* 18 (Berkeley Roundtable on the Int'l Econ., Working Paper No. 143, 2002).

vention.[9] The reforms in the 1990s created a strong and competitive market in the global world. Some of the major reforms included the removal of the erstwhile existing financial repression, and the creation of an efficient, productive, and profitable financial sector.[10] The state also provided operational and functional autonomy to institutions and opened the external sector in a calibrated manner.

Furthermore, several reforms were made in the banking sector, foreign exchange, and securities markets. All these reforms had a positive impact on the economy of the country. For example, this led to the development of a robust commercial banking system in India—a fact which is clear from Table 1 below.[11]

TABLE ONE Commercial Banking

		1969	1980	1991	2000	2005
	1	2	3	4	6	9
1	No. of Commercial Banks	73	154	272	298	288
2	No. of Bank Offices	8,262	34,594	60,570	67,868	68,339
	Of which					
	Rural and semi-urban bank offices	5,172	23,227	46,550	47,693	47,491
3	Population per Office ('000s)	64	16	14	15	16
4	Deposits (per cent of National Income)	16	36	48	54	65

As can be seen from the table, the number of commercial banks has increased four times from 1969 to 2005 while the number of bank offices has increased more than eight times for the same period. Though the number of people to whom the bank offices are now available has not changed significantly since 1980, the banks' availability has increased four times since 1969 for the total population. In addition to the banking sector, India has had a fairly well developed stock market, and with substantial deregulation, India has seen some large scale improvement in the primary market and investments as well.

But there are certain infrastructure constraints on India that the market managers and economists find to be a hurdle to economic development.[12] One of the fundamental reasons for poor infrastructure in India has been the widespread corruption at various levels of state and central governments. Apart from that, there has been a total lack of vision and planning by the caretakers of the economy and a shortage of funds. Specialty sectors like transport, including roads and railways, have been poorly maintained although they are

9. *See* R.N. Ghosh, *The Globalization Process and Economic Liberalization in India: Lessons from Classical Economics*, *in* ECONOMIC INSTITUTIONS IN INDIA: SUSTAINABILITY UNDER LIBERALIZATION AND GLOBALIZATION 265 (Parthasasathi Banerjee & Frank-Jurgen Richter eds., 2003).

10. Rakesh Mohan, Deputy Governor, Reserve Bank of India, Speech at the Conference on Economic Policy in Asia at Stanford: *Financial Sector Reforms and Monetary Policy: The Indian Experience* (June 2, 2006).

11. *Id.*

12. *See* T.N. SRINIVASAN & SURESH TENDULKAR, REINTEGRATING INDIA WITH THE WORLD ECONOMY (2003).

highly used.[13] But as highlighted earlier, in the financial sector, India has made a greater effort and has succeeded.

III. Major Modes of Investments in India

A. Introduction

Since the opening of the markets, there have been three major modes of investment in India: (1) direct investment; (2) offshore company (usually in Mauritius)[14] operating in India; or (3) direct investment in venture capital funds. The Foreign Investment Promotion Board (FIPB) regulates the Foreign Direct Investments (FDIs) in India. The FIPB, in collaboration with the Reserve Bank of India (RBI),[15] monitors foreign investment and foreign exchange flow. The FIPB and Securities Exchange Board of India (SEBI) regulate investments in foreign venture capital funds. These three modes are described in more detail below.

B. Foreign Direct Investment

FDI in India is governed by the FDI policy of the Government of India and the FIPB. For most of the FDIs, there is an automatic approval route available to investors, which do not need any government approval for investments in India (only procedural filings have to be made with the RBI).[16] For all other activities where the automatic approval route is not available, FIPB gives the approval. There are, however, certain activities that are prohibited from receiving FDIs, such as retail trading, atomic energy, lottery business, housing and real estate business, and agriculture and plantations.

Indian companies receiving foreign investment approval through the FIPB do not require any further clearance from RBI to receive inward remittance or to issue shares to the foreign investors.[17] These companies are required to notify the RBI of a receipt of inward remittances within thirty days of such receipt and file required documentation within thirty days of issue of shares to foreign investors. FDI is also 100 percent permitted under the automatic route for companies setting up special economic zones, industrial parks, or export oriented units.

13. *See id.* at 119.

14. "According to SEBI records there are 72 registered domestic venture capital funds (DVCF) and 37 registered foreign venture capital investors (FVCI). All but one of the foreign investors are based in Mauritius and nearly half of these seem to share the same address." Government of India Planning Commission New Delhi, *Report of the Committee on Technology Innovation and Venture Capital* 8 (July 2006), *available at* http://iis-db.stanford.edu/pubs/21321/rep_vcr.pdf [hereinafter The Report].

15. Reserve Bank is the central bank of India that issues currency, administers foreign exchange, and regulates most of the banking operations in India.

16. For example, 100 percent FDI is allowed in non-banking financial companies, pharmaceuticals and drugs, advertising, films, power, in Indian companies engaged in petroleum products/refining, for non-resident Indians investment in real estate, etc.

17. *See* Rohit Sachdev, *Comparing the Legal Foundations of Foreign Direct Investment in India and China: Law and the Rule of Law in Indian Foreign Direct Investments*, 2006 COLUM. BUS. L. REV. 167, 201 (2006).

C. Offshore Companies

An offshore company is one that is incorporated in one jurisdiction but carries out most of its business in another jurisdiction. In India, establishing an offshore company in Mauritius is particularly beneficial because of the double taxation avoidance agreement in place between the two countries and the ease of establishing a company in Mauritius.

A company incorporated outside Mauritius can register itself in Mauritius and is then treated, for most purposes, as a Mauritius-incorporated company.[18] Even an offshore trust can be established in Mauritius, and these trusts are taxed in the same manner as offshore companies. Any amount distributed to non-resident beneficiaries is exempt from income tax. An offshore company/trust is allowed a credit for foreign tax on its foreign-source income. For these reasons, most of the offshore companies investing in India are registered in Mauritius.

D. Venture Capital Investment

To invest in venture capital, an investor may incorporate a company or form a trust. A foreign company can establish a place of business[19] in India as a foreign company under Section 591 of the Companies Act 1956 or as a domestic Indian company incorporated in India under Section 3 of that Act Otherwise, a venture capital fund can be created as a trust under the provisions of the Indian Trusts Act 1882 (the "Trusts Act"). According to Section 7 of the Trusts Act, a trust can be created by any person competent to contract. The only condition is that the trust should be created for a lawful purpose.[20] Although the application process and eligibility criteria for granting a certificate of registration are almost the same both for domestic and foreign venture capital funds, there are slight differences in the conditions for the grant of the certificate.[21] While a domestic fund is not allowed to carry on any activity other than the venture capital fund,[22] a foreign investor must appoint a domestic custodian and should have a foreign currency account in one of the designated banks.[23] Also, a domestic fund is not allowed to invest more than 25 percent of the funds in one venture undertaking.[24]

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18. *See generally* Lowtax.net, http://www.lowtax.net/lowtax/html/jmuhom.html.

19. This can be a wholly owned subsidiary or joint venture as an incorporated entity and branch or liaison office as an unincorporated entity.

20. Section 4 provides:

> the purpose of a trust is lawful unless it is (a) forbidden by law, or (b) is of such a nature that, if permitted, it would defeat the provisions of any law, or (c) is fraudulent, or (d) involves or implies injury to the person or property of another, or (e) the Court regards it is as immoral or opposed to public policy.

The Indian Trusts Act, No. 2 of 1882, India Code (1993), v. 8.

21. *See* Mike Wright et. al., *Venture Capital Firm Internationalization and Monitoring High Tech Entrepreneurship: The Case of India*, *in* Technological Entrepreneurship 149 (Phillip H. Phan, ed., 2002).

22. SEBI (Venture Capital Funds) Regulations, 1996 § 8(b).

23. SEBI (Foreign Venture Capital Investors) Regulations, 2000 §§ 8(b)-(c).

24. SEBI (Venture Capital Funds) Regulations 1996 § 12(b).

IV. Development of Venture Capital in India

Venture capital activities in India started around the late 1980s. The establishment of the Technology Development Fund in 1987 and 1988 laid the foundation of the modern system of venture capital.[25] Later in 1996, the SEBI took an initiative to lay down guidelines for venture capital funds. These regulations were revised in 2000 when the SEBI Foreign Venture Capital Investor Regulations (FVCIR)[26] were passed.

A. Market Conditions and the Flow of Venture Capital

Venture capital investment proves a boon for any economy because it supports growth of local industries and creates employment. But there are various factors to consider before determining whether or not to invest in a particular market.[27] For example, the social, legal, and economic structure of the markets should be considered. The more flexible and reliable the market, the more lucrative a place for investment it would be. Additionally, a prospective venture capitalist will consider the nature of regulation and procedure at the entry and exit stage. Foreign investment would flow only in places where there are the least procedural and regulatory networks.

The Indian legal system provides an impetus to enhance business opportunities and protect the rights of investors. The government has been keen to create a conducive environment by amending relevant laws and introducing simpler regulations to attract more and more venture capital. Also, the Indian market for venture capital investment has been driven by several other variables. First, there are strong knowledge-based industries that are growing fast, are global in nature, and are hardly affected by domestic issues. Second, there are world class engineers and professionals whose success is evident even abroad, such as in the United States. Third, India has the second largest English-speaking population that has a strong knowledge of mathematics and science. Last, India has advanced some of its sectors, such as the information technology and media sector, in the last two decades and is on par with global standards.[28]

But there is still a need for continuous effort and reform. According to Ghosh,[29] there are some areas which are still of concern for India. First, there is a need for maintaining a balance between the market and its regulatory framework. Second, there must be a system in place for competent manpower in the regulatory institutions with safeguards for maintaining their autonomy. Third, there is a need to improve corporate governance and financial discipline. Additionally, more investment is needed in the education, research,

25. *See* Taxnews.com, Lowtax Guide to Venture Capital, http://www.tax-news.com/reports/V92220/vc_india.asp.

26. *See infra* Part V.

27. *See generally* Fred M. Greguras et. al., Fenwick & West L.L.P., *2006 Update to Structuring Venture Capital and other Investments in India, available at* http://www.fenwick.com/docstore/Publications/Corporate/2006_Structuring_VC.pdf.

28. *See* Saurabh Srivastava, Chairman, India Venture Capital Association, Presentation: State of Venture Capital in India (Oct. 20, 2004) *available at* http://www.tienewdelhi.org/members/boston_vc_delegaton_presentations.asp.

29. D.N. Ghosh, India and China: Partnership or Rivalry in a Globalising World, http://www.epw.org.in/epw/uploads/articles/8545.pdf.

and training of human resources. These deficiencies and shortages can only be dealt with through supportive economic conditions and further reforms by the government.

B. Venture Capital Trend in India

The Indian venture capital investment trends of the last decade are shown in Figure 1 below.[30]

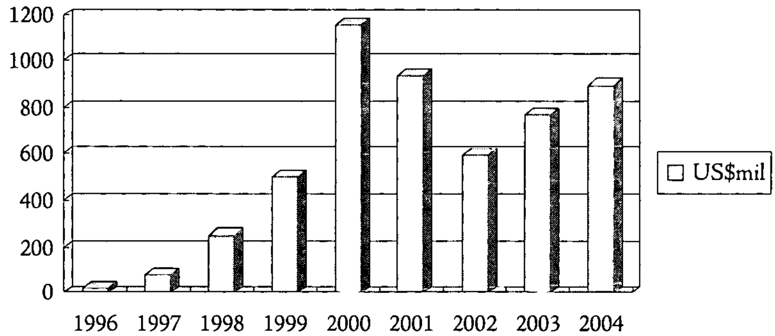

Figure 1: India Venture Capital Investment Trend

It is apparent from Figure 1 that there was negligible investment in 1996. But there was steady growth until 2000 when the level of investment reached its peak. The level declined in the following years but has again picked up pace in the past couple of years.

In order to closely analyze the venture capital trend in India, it will also be useful to look at three specific aspects of the trend: the source of investment, the stages, and the sectors. The following tables show the list of institutions/sectors that have been the main contributors of investment and at the different stage of the venture in India.[31]

TABLE TWO Sources of Venture Capital and Disbursement by Financing Stage

Source	Per cent	Stage	Per cent
Corporations	46	Expansion	49
Banks	23	Start-up	36
Pension Funds	12	Seed	7
Insurance Companies	10	Buyout	4
Government Agencies	5	Mezzanine	4
Private Individuals	4		

30. *See* Srivastava, *supra* note 28.

31. Asian Venture Capital Journal, The 2003 Guide to Venture Capital in Asia, 470, 472 (14th ed. 2003).

It is clear from Table 2 that while companies have been the major source of investment in India, it is the expansion stage that is the most favored stage for investment. In 2006, the industries or sectors that can be considered "hot industries"—industries where investments were made—have been the following:[32]

TABLE THREE The Hot Industries

Industry	Apr-Jun 06	
	Volume % share	Value US$ mil.
IT & ITES	18	950
Manufacturing	22	200
Healthcare & Life Science	7	60
Banking & Fin. Ser.	11	265
Engg. & Constr.	17	372
Food & Beverages	8	68
Others	17	170

It has been noted in recent years that the IT sector in India has been outperforming all other sectors. It is the one industry where most of the venture capitalists are headed in India. But the IT boom in India has provided opportunities for other industries to grow as well, which is evident from Table 3. Manufacturing, especially textiles, has attracted a lot of venture capital from abroad. Banking and healthcare industries are also in the running for such investments.

But there are certain impediments to the development of venture capital markets in India.[33] For example, India's company law does not provide for limited partnerships or limited liability partnerships. The tax restrictions on corporations require that companies paying dividends must pay a 10 percent dividend distribution tax on the aggregate dividend, and India's currency, the Rupee, is not fully convertible.[34]

In September 2005, the Planning Commission of the Government of India formed a committee on Technology Innovation and Venture Capital. The committee's report was released in July 2006.[35] Dr. Dossani, a member of the committee, has indicated other deficiencies in the venture capital scene. According to Dr. Dossani, the entrepreneurs in India possess domain and cost-management skills but do not know how to develop early-stage ideas into viable businesses. Their networks consist primarily of limited personal connections and brokers. Further, the risk capital providers possess portfolio diversification and risk assessment skills but lack the domain expertise to guide entrepreneurs to create successful businesses. There is also a shortage of complimentary capital, such as

32. Arun Natarajan, *India Roundup Quarterly* 4 (Apr.-June 2006), *available at* http://www.ventureintelligence.in/India_Roundup.pdf.

33. *See* Dossani & Kenney, *supra* note 8.

34. The rupee is fully convertible on the current account, which covers external trade in goods and services but only partially convertible on the capital account.

35. The Report, *supra* note 14.

debt capital, and the equity markets are underdeveloped for the listing of early stage firms, which limits the transition into and from early stage investments. Additionally, there is an inadequate pipeline of university/state funded seed-stage firms seeking early-stage funding and a lack of university-industry collaborations.

But as mentioned earlier, these shortages can be overcome with consistent effort and training. Also, if there are fewer procedures to follow and easy to understand regulations, the investment system can work more efficiently. The government could take the initiative to prepare a user-friendly manual whereby investors, whether domestic or foreign, would be able to get some guidance. The manual could be a source whereby investors may know the structure of the market, the regulations applicable, statistical data for investment, etc.

V. Regulation of Venture Capital in India

Venture capital investment is governed by various rules and regulations of the legal system of the country where it exists. There are basically two major statutes that govern venture capital investment in India, namely the Foreign Exchange Management Act (FEMA) and the Securities Exchange Board of India Act of 1992 (SEBI). Under these two Acts, various regulations specifically dealing with venture capital were issued, both for the overseas and domestic investor. The RBI also issues regulations and guidelines for foreign investment and administers exchange controls. Additionally, the FIPB reviews investment proposals, which require government approval. All of these regulatory bodies are governed by the central government.

A. The Foreign Exchange Management Act

The Foreign Exchange Regulation Act of 1973 (FERA) was repealed to make way for the new FEMA in 1999. FEMA was enacted "to consolidate and amend the law relating to foreign exchange with the objective of facilitating external trade and payments and for promoting the orderly development and maintenance of the foreign exchange market in India."[36] Under FEMA, the RBI made certain regulations to prohibit, restrict, and regulate certain transfers or issues of securities by foreigners in India. These regulations are known as the Foreign Exchange Management (Transfer or Issue of Security by a Person Resident Outside India) Regulations of 2000.

Most of the definitions provided in these regulations are similar to those provided by SEBI and place certain restrictions on equity preference/convertible preference shares and convertible debentures issued by an Indian company to a person/corporate body outside India. As compared to FERA, FEMA is an investment-friendly legislation. There is an automatic approval for most investments available from the RBI but not for certain activities.[37] There are also certain investment caps on different industries;[38] for example, bank-

36. The Foreign Exchange Management Act, No. 42 of 1999; India Code.

37. *E.g.*, petroleum, investments in infrastructure and services sector like natural gas pipelines, defense and strategic industries, atomic minerals, print media and broadcasting, postal and courier services, tea sector, etc. The Foreign Exchange Management (Transfer or Issue of Security by a Person Resident Outside India) Regulations, 2000, Annexure A.

38. *Id.* at Annexure B.

ing (74 percent), mining (74 percent), trading (51 percent), aviation (40 percent), telecommunications (49 percent), cable network (49 percent), print media (26 percent), defense equipment (26 percent), insurance (26 percent), and small-scale industries (24 percent).

B. The Role of SEBI

SEBI is a corporate body governed by the central government established under Section 3 of the SEBI Act of 1992.[39]The main functions of the body, as its name suggests, are the regulation of stock exchanges and share markets, registration of brokers and persons associated with such markets, and regulation and registration of venture capital funds, both domestic and foreign. SEBI was established "to protect the interests of investors in securities and to promote the development of, and to regulate, the securities market."[40]

The SEBI (Venture Capital Funds) Regulations were formulated in 1996 to regulate the domestic venture capital funds (DVCF) and to require registration of such funds. It was only in 2000 that legislation was passed specifically dealing with foreign venture capital in India. The SEBI (Foreign Venture Capital Investors) Regulations of 2000 define a "foreign venture capital investor" (FVCI) as an investor that: (1) is incorporated and established outside India; (2) is registered under these regulations; and (3) proposes to make investments in accordance with the SEBI regulations.[41]

"Venture Capital Fund" (VCF), as defined by the regulation, means a fund established in the form of a trust or a company, including a corporate body, and registered under SEBI Regulations.[42] Such a trust/company should have a dedicated pool of capital that is raised and invested in the manner specified under the regulations. "Venture Capital Undertaking" (VCU)[43] is defined in the regulations as a domestic company whose shares are not listed in a recognized stock exchange in India and that is "engaged in the business of providing services, production, or manufacture of articles or things or does not include such activities or sectors which are specified in the negative list by the Board." India has opened its market to various investments and encourages investment in almost all sectors. The negative list of industries is declining, and most of the applications for direct investment have automatic approval from the government. In fact, SEBI provides that non-banking financial services, gold financing, and activities not provided under the industrial policy of the government are the only sectors that fall in the negative list of foreign venture capital investment.[44]

For purposes of receiving benefits under the SEBI Regulations, an overseas investor must be registered as an FVCI. Before registration, the board would consider certain conditions for eligibility, such as the applicant's track record, professional competence, financial soundness, experience, and general reputation of fairness and integrity.[45] The

39. *See* Securities and Exchange Board of India, *About SEBI*, http://www.sebi.gov.in/Index.jsp?contentDisp=AboutSEBI (last visited February 14, 2008).

40. The Securities and Exchange Board of India Act, No. 15 of 1992; India Code.

41. SEBI (Foreign Venture Capital Investors) Regulations, 2000 § 2(g).

42. SEBI (Venture Capital Funds) Regulations, 1996 § 2(m).

43. SEBI (Venture Capital Funds) Regulations, 1996 § 2(n).

44. SEBI (Foreign Venture Capital Investors) (Amendment) Regulations, 2004, Third Schedule.

45. SEBI (Foreign Venture Capital Investors) Regulations, 2000 § 4.

board would also consider the following: whether the applicant is an investment company, a trust, partnership, pension fund, mutual fund, endowment fund, university fund, charitable institution, or any other entity incorporated outside India; or whether an asset management company, investment manager or management company, or any other investment vehicle incorporated outside India. The board would also inquire as to whether the applicant has previously been denied a certificate by the board and whether the applicant is a fit and proper person.[46]

Further, under Chapter III, the SEBI Regulations of 2000 establish investment conditions and restrictions. The investment criteria for a venture capital investor require that it shall disclose to the board its investment strategy and can invest its total funds committed in one venture capital fund.[47] But the investor must invest at least 66.67 percent of the investable funds in unlisted equity shares or equity linked instruments of VCU. Moreover, not more than 33.33 percent of the investable funds may be invested for subscription to initial public offers of a venture capital undertaking whose shares are proposed to be listed. And no more than 33.33 percent may be invested in debt or a debt instrument of a venture capital undertaking that the foreign venture capital investor has already made an investment by way of equity. The 33.33 percent investment limit is also applicable to preferential allotment of equity shares of a listed company subject to a lock-in period of one year, the equity shares or equity linked instruments of a financially weak company,[48] or a sick industrial company whose shares are listed and/or special purpose vehicles that are created for the purpose of facilitating or promoting investment. The venture capital investor must also disclose the duration of the life cycle of the fund.

Registration under SEBI seems to be a bit bureaucratic, but it offers certain benefits. For example, income is passed through to investors without tax in f trusts registered under the Indian Trusts Act and venture capital companies. FVCIs can freely remit funds to India for investments in Indian VCUs and SEBI registered DVCFs.[49] The are also exempt from both the entry and exit pricing regulations that otherwise apply to foreign investors, such as market-related pricing on divestment. Additionally, the sale of shares by VCFs to company insiders (post listing) are exempt from the SEBI takeover code. Further, VCFs automatically obtain Qualified Institutional Buyer (QIB) status, which is useful for participating in new security placements, and they get exemption from the one-year lock-in for divestment post-initial public offering (IPO) for shares purchased prior to the IPO and are not treated as promoters for purposes of IPO.[50]

C. The Promotion of Investment by FIPB

The FIPB is a special board of the Government of India comprised mainly to promote inflows of FDI into the country. It also provides appropriate institutional arrangements,

46. *See* SEBI (Criteria for Fit and Proper Person) Regulations, 2004. ("Fit and Proper person" has been defined as including financial integrity, competence, good reputation, honesty, etc.)

47. SEBI (Foreign Venture Capital Investors) (Amendment) Regulations, 2004 § 11.

48. "Financially weak company" means a company that has, at the end of the previous financial year, accumulated losses that resulted in the erosion of more than 50 percent but less than 100 percent of its net worth as at the beginning of the previous financial year.

49. But, as mentioned earlier, these benefits are subject to certain restrictions, such as which industry to invest.

50. The Report, *supra* note 14.

transparent procedures, and guidelines for investment promotion and considers and approves/recommends foreign investment proposals. With the increasing liberalization of the Indian economy there, generally is no need to obtain prior approval from the Government of India to make a fresh investment in an Indian company. All items/activities for FDI up to 100 percent by Non-Resident Indians (NRI)/Overseas Corporate Bodies (OCB) fall under the automatic route unless they expressly require prior government approval.

As mentioned earlier, equity participation by international financial institutions in domestic companies is permitted through the automatic route subject to SEBI/RBI regulations and sector specific-caps on FDI. But for all proposals requiring an industrial license and where the foreign collaborator has a previous venture/tie-up in India in the same or allied field (except for the information technology industry), government approval for FDI/NRI/OCB through the FIPB is necessary.

Similar approval is also required for all proposals relating to the acquisition of shares in an existing Indian company, proposals falling outside notified sector policy/caps or under sectors for which FDI is not permitted, and/or whenever any investor chooses to make an application to the FIPB and not avail itself to the automatic route. Indian companies obtaining foreign investment approval through the FIPB route do not require any further clearance from RBI to receive inward remittance or issue shares to foreign investors.

VI. Taxation of Venture Capital in India

The main taxes levied by the central government in India are the income tax, central excise and sales tax, service tax, and customs duties.[51] The states can levy additional value added tax, stamp duty, state excise, land revenue, and tax on professions.[52] India has not only seen economic and market reforms in the past two decades but also some tax reforms. The government has tried to make the system transparent and friendly to honest taxpayers.[53] The reforms have also been aimed at foreign investors who could either be impressed with a sound and friendly tax system or be discouraged by a rigid and unpractical tax regime.

A. Tax Benefits

The Indian Income Tax Act 1961 (ITA) exempts income, dividend, and capital gains earned from venture capital investment in India. Section 10 of the ITA provides for incomes that are not included in total income for the year. The venture capital investment benefits are established in clauses 23F, 23FA and 23 FB of Section 10.[54] Any income by way of dividends[55] 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 is exempt from income tax.

51. India Const. art 246.
52. *Id.* at art. 276.
53. *See* Shankar N. Acharya, Essays on Macroeconomic Policy and Growth in India, (2006).
54. The benefit of this exemption is, however, subject to certain conditions discussed later.
55. Except for dividends out of distributed profits declared between June, 1 1997 to March 31, 2002 *See* The Income Tax Act, No. 43 of 1961; India Code § 115-O.

For purposes of these clauses, "venture capital fund" means a fund operating under a trust deed registered under the provisions of the Registration Act of 1908, which was established to raise monies by the trustees for investments, mainly by way of acquiring equity shares of a venture capital undertaking in accordance with the prescribed guidelines. "Venture capital company" means a company that has made investments by acquiring equity shares of venture capital undertakings in accordance with the prescribed guidelines. It is worthwhile to see the provisions, themselves. Section 10 (23F) states:

> Under this clause "venture capital undertaking" means such domestic company whose shares are not listed in a recognized stock exchange in India and which is engaged in the business or generation and distribution of electricity or any other form of power or engaged in the business of providing telecommunication services or in the business of developing, maintaining and operating any infrastructure facility or engaged in the manufacture or production of such articles or things (including computer software) as may be notified by the Central Government in this behalf. "Infrastructure facility" means road, highway, bridge, airport, port, rail system, water supply project, irrigation project, sanitation and sewerage system, or any other public facility of a similar nature as may be notified by the Board in this behalf.[56]

Section 10 (23FA) provides the following:

> Under this clause "venture capital undertaking" means such domestic company whose shares are not listed in a recognised stock exchange in India and which is engaged in the business of software, information technology, production of basic drugs in the pharmaceutical sector, biotechnology, agriculture and allied sectors, or such other sectors as may be notified by the Central Government in this behalf or is engaged in the production or manufacture of any article or substance for which patent has been granted to the National Research Laboratory or any other scientific research institution approved by the Department of Science and Technology.

And Section 10 (23FB) set forth that "[f]or the purposes of this clause, 'Venture capital undertaking' means a venture capital undertaking referred to in the SEBI Regulations of 1996 and notified as such in the Official Gazette by the Board for the purposes of this clause."

Basically, Sections 10 (23F), (23FA) and (23FB) provide that for exemption under these clauses, the venture capital fund has to be a registered fund, either under the Registration Act or the SEBI Act and Regulations. The venture capital company must have made investment by acquiring equity shares in the invested enterprise, and the enterprise/undertaking must be carrying on activities specified by the ITA.

For example, to be exempt from paying tax on dividends or capital gains, the undertaking should either be engaged in power generation or any other infrastructure facility for business. It may also carry on the business of software or biotechnology, etc. Further, for income to be exempt from income tax, the venture capital company or fund must be registered under the SEBI, and the VCU should comply with the definition under the SEBI Regulations. The only condition for income tax benefit on income is that it should not be engaged in an activity prohibited by law.

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56. *See id.* at § 80-IA.

The Central Board for Direct Taxes has prescribed certain guidelines for approving a venture capital fund or company for tax exemptions.[57] These guidelines are briefly discussed here. Every application for approval shall be accompanied by: a copy of trust deed or certificate of incorporation under the Companies Act; balance sheets and profit and loss accounts for three years immediately preceding the year in which the application is made; and a copy of the certificate of registration from SEBI.[58] The Director of Income Tax (Exemption) will approve the venture capital fund or the venture capital company, subject to certain conditions.

One of these conditions is that the venture capital fund or the venture capital company must be registered with SEBI. Also, every venture capital fund/company must invest an amount not less than 80 percent of its total money raised for investment by acquiring equity shares of the venture capital undertaking, and 20 percent or more of such money must be invested during or before the end of the year prior to the application by acquiring equity shares of the venture capital undertaking. Fifty percent or more of such money must be invested during or before the end of the year prior to that where a 20 percent was made by acquiring equity shares of the venture capital undertaking. Furthermore, 80 percent or more of such money must be invested during or before the end of the year immediately succeeding the year in which 50 percent investment referred to above has been made by acquiring equity shares of the venture capital undertaking.

A venture capital fund or venture capital company shall not invest more than 20 percent of its total money raised or total paid up capital in one venture undertaking. A venture capital fund or a venture capital company shall not make an investment of more than 40 percent of the equity capital of one venture capital undertaking. Also, where a taxpayer is based in a country that has a double taxation avoidance agreement (DTAA) with India, it may opt to be taxed either under the ITA or its country of residence, whichever is more beneficial.[59]

VII. The Exit Strategy

One of the main characteristics of a venture capital investment is that it is usually a fixed term investment, and the investor would like to exit from the venture within three to five years. In fact, the exit may come earlier if the venture capitalist finds that the project would be a total loss. There are various modes of exit available to a venture capitalist, depending upon the stage at which the investment was made.[60] The most common exit alternatives are: initial public offering (IPO); buy-back by promoters of the company; sale of the enterprise (to another company or investor); and winding up.

Once a capital venture becomes successful and is capable of raising funds from the public, it can opt for the IPO. There, the shares of the company are offered to other investors, and the initial venture capital investors may withdraw from the venture. This gives the company an opportunity to raise funds and to attract new management. But the com-

57. *See* Thebharat.com, Venture Capital-Income Tax Benefits, http://www.thebharat.com/legal/venture capital/incometaxbenefits.html.

58. *See id.*

59. The Income Tax Act, No. 43 of 1961; India Code § 90 (2).

60. *See* DAVID GLADSTONE & LAURA GLADSTONE, VENTURE CAPITAL HANDBOOK: AN ENTREPRENEUR'S GUIDE TO RAISING VENTURE CAPITAL (rev. ed. 2002).

pany may also decide to buy back its shares from the initial investors if it has gained the capacity to do so. The successful venture also has the option to be sold to a new company or investor for further expansion. Arikan argues that "the discrete choice between choosing to auction off a company through an IPO or to negotiate its sale as a privately held target rests on five factors: bargaining power, resource value, market thickness, risk propensity and search costs."[61]

Finally, if the venture has not performed well, it can be liquidated. According to Regulation 23 of the SEBI Regulations of 1996, a scheme of a venture capital fund set up as a trust could be wound up when:[62] (1) the period of the scheme, if any, mentioned in the placement memorandum is over; (2) it is the opinion of the trustees or the trustee company that the scheme shall be wound up in the interests of investors in the units; (3) 75 percent of the investors in the scheme pass a resolution at a meeting of unit holders that the scheme be wound up; or (4) the board so directs in the interests of investors. If the venture capital fund is set up as a company, it must be wound up in accordance with the provisions of the Companies Act.[63] Additionally, a venture capital fund set up as a corporate body must be wound up in accordance with the provisions of the statute under which it was formed.

According to Regulation 24, the effect of a winding up is that no further investments can be made on behalf of the scheme, and, within three months from the date of intimation, the assets of the scheme are liquidated, and the proceeds accruing to investors in the scheme must be distributed to them after satisfying all liabilities. Further, in-specie distribution of assets may be made by the venture capital fund at any time, including on winding up, as per the preference of investors or after obtaining approval of at least 75 percent of the investors. The Venture Capital Insight Report 2006, prepared by Ernst & Young, found that there has been a significant increase in venture-backed exits, and the trend is set to continue in 2007.[64]

VIII. Conclusion

Venture capital investment was growing trend in the past few decades. India has kept pace with that growing trend for almost two decades. Since the humble beginnings in the 1980s, India has come a long way in making itself a preferred investment hub. Its legal system and economy have been conducive to foreign investment along with various progressing industries, like the IT sector. India has a well-established system of law and follows the English common law system. The strong banking structure and developed stock market has provided the basic infrastructure for investments to grow.

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61. *See* Ilgaz Arikan, *Exit Decisions of Entrepreneurial Firms: IPOs Versus M&As, in* Ginsberg & Hasan, *supra* note 1.

62. The Indian Trusts Act, No. 2 of 1882; India Code. Section 77 provides that a "trust is extinguished—(a) when its purpose is completely fulfilled; or (b) when its purpose becomes unlawful; or (c) when the fulfillment of its purpose becomes impossible by destruction of the trust-property or otherwise; or (d) when the trust, being revocable, is expressly revoked."

63. The Companies Act, No. 1 of 1956; India Code (1956), v. 2. Section 484 of this act provides for circumstances under which voluntary winding up of a company may occur.

64. *See* Ernst & Young, *Exits Set to Increase Worldwide as Venture Capital Industry Continues to Globalize* (May 3, 2006), *available at* http://www.ey.com/global/content.nsf/International/SGM_-_Venture_Capital_Insight_Report_2006.

But there are still a few constraints on the economy that have slowed the pace of venture capital investment. The railway/road network and the energy sector both need improvement. The equity market is also not well-developed for early-stage investment. Though the government has been keen to reduce such constraints, there is still much to be done, including the reduction of regulation over free-flow of various investments.

The main legislation regulating venture capital investment is the SEBI Act and FEMA. Since the reforms in the 1990s and the introduction of specific SEBI legislation on foreign venture capital investment, India has witnessed an increased growth in investment. But the recent report by the Technology Innovation and Venture Capital Committee highlighted certain areas in which India still needs to work and make better efforts. India needs to provide a market that would encourage early-stage investment and train its business people to make better investment decisions. There should also be greater effort in coordinating the education sector and the investment market.

Venture capital investment can only grow in conditions where there is a flexible market with opportunities and a structure that is less regulated. Too many rules and regulations confuse the investors and discourage them at the entry stage, itself. India should contemplate creating a venture capital investment manual for domestic and foreign venture capitalists that investors can refer to whenever they need to make investment decisions. The manual should have all the relevant acts, rules, procedures, forms, etc. Apart from that, the manual may introduce the investor to the basic socio-legal and economic structure of the country. It may also include some sound advice on how and where to invest, including some statistics for reference. The task of preparing such a manual may seem overwhelming, but the Indian government is well to undertake the task. The availability of the document would make it easier and simpler for investors come to a decision and invest.