



Report of K.B. Chandrasekhar Committee on Venture Capital

Executive Summary

I. Why venture capital

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

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

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



II. Critical factors for success of venture capital industry:

While making the recommendations the Committee felt that the following factors are critical for the success of the VC industry in India:

- (A) The regulatory, tax and legal environment should play an enabling role. Internationally, venture funds have evolved in an atmosphere of structural flexibility, fiscal neutrality and operational adaptability.
- (B) Resource raising, investment, management and exit should be as simple and flexible as needed and driven by global trends
- (C) Venture capital should become an institutionalized industry that protects investors and investee firms, operating in an environment suitable for raising the large amounts of risk capital needed and for spurring innovation through startup firms in a wide range of high growth areas.
- (D) In view of increasing global integration and mobility of capital it is important that Indian venture capital funds as well as venture finance enterprises are able to have global exposure and investment opportunities.
- (E) Infrastructure in the form of incubators and R&D need to be promoted using Government support and private management as has successfully been done by countries such as the US, Israel and Taiwan. This is necessary for faster conversion of R & D and technological innovation into commercial products.

Recommendations:

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



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

3. Mobilisation of Global and Domestic resources:

(A) Foreign Venture Capital Investors (FVCIs):

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

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

- (i) Venture capital is a high risk area. In out of 10 projects, 8 either fails or yield negligible returns. It is therefore in the interest of the country that FVCIs bear such a risk.*
- (ii) For venture capital activity, high capitalisation of venture capital companies is essential to withstand the losses in 80% of the projects. In India, we do not have such strong companies.*



(iii) *The FVCIs are also more experienced in providing the needed managerial expertise and other supports.*

(B) *Augmenting the Domestic Pool of Resources:*

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

4. *Flexibility in Investment and Exit:*

(A) *Allowing multiple flexible structures:*

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

(B) *Flexibility in the matter of investment ceiling and sectoral restrictions:*

70% of a venture capital fund's investible funds must be invested in unlisted equity or equity-linked instruments, while the rest may be invested in other instruments. Though sectoral restrictions for investment by VCFs are not consistent with the very concept of venture funding, certain restrictions could be put by specifying a negative list which could include areas such as finance companies, real estate, gold-finance, activities not legally permitted and any other sectors which could be notified by SEBI in consultation with the Government. Investments by VCFs in associated



companies should also not be permitted. Further, not more than 25% of a fund's corpus may be invested in a single firm. The investment ceiling has been recommended in order to increase focus on equity or equity-linked instruments of unlisted startup companies. As the venture capital industry matures, investors in venture capital funds will set their own prudential restrictions.

(C) Changes in buy back requirements for unlisted securities:

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

(D) Relaxation in IPO norms:

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

(E) Relaxation in Takeover Code:

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

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

In order to facilitate investment by VCF in new enterprises, the Companies Act may be amended so as to permit issue of shares by unlisted public companies with a differential right in regard to voting and dividend. Such a flexibility already exists under the Indian Companies Act



in the case of private companies which are not subsidiaries of public limited companies.

- (G) **QIB Market for unlisted securities:** *A market for trading in unlisted securities by QIBs be developed.*
- (H) **NOC Requirement :** *In the case of transfer of securities by FVCI to any other person, the RBI requirement of obtaining NOC from joint venture partner or other shareholders should be dispensed with.*
- (I) **RBI Pricing Norms:** *At present, investment/disinvestment by FVCI is subject to approval of pricing by RBI which curtails operational flexibility and needs to be dispensed with.*

5. **Global integration and opportunities:**

- (A) **Incentives for Employees:** *The limits for overseas investment by Indian Resident Employees under the Employee Stock Option Scheme in a foreign company should be raised from present ceilings of US\$10,000 over 5 years, and US\$50,000 over 5 years for employees of software companies in their ADRs/GDRs, to a common ceiling of US\$100,000 over 5 years. Foreign employees of an Indian company may invest in the Indian company to a ceiling of US\$100,000 over 5 years.*
- (B) **Incentives for Shareholders:** *The shareholders of an Indian company that has venture capital funding and is desirous of swapping its shares with that of a foreign company should be permitted to do so. Similarly, if an Indian company having venture funding and is desirous of issuing an ADR/GDR, venture capital shareholders (holding saleable stock) of the domestic company and desirous of disinvesting their shares through the ADR/GDR should be permitted to do so. Internationally, 70% of successful startups are acquired through a stock-swap transaction rather than being purchased for cash or going public through an IPO. Such flexibility should be available for Indian startups as well. Similarly, shareholders can take advantage of the higher valuations in overseas markets while divesting their holdings.*
- (C) **Global investment opportunity for Domestic Venture Capital Funds (DVCF):** *DVCFs should be permitted to invest higher of 25% of the fund's corpus or US \$10 million or to the extent of foreign contribution in the fund's corpus in unlisted equity or equity-linked investments of a foreign company. Such investments will fall within the overall ceiling of 70% of the fund's corpus. This will allow DVCFs to invest in synergistic*



startups offshore and also provide them with global management exposure.

6. Infrastructure and R&D :

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

7. Self Regulatory Organisation (SRO):

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

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



**REPORT OF K B CHANDRASEKHAR COMMITTEE
ON VENTURE CAPITAL**

1.0 PREFACE

- 1.1 *Technology and knowledge based ideas will drive the global economy in the 21st century. India's recent success story in the area of information technology has shown that there is a tremendous potential for the growth of knowledge based industries. This potential is not only confined to information technology but is equally relevant in several areas such as bio-technology, pharmaceuticals, media and entertainment, agriculture and food processing, telecommunication and other services. Given the inherent strength by way of its human capital, technical skills, cost competitive manpower, research and entrepreneurship, India can unleash a revolution of wealth creation leading to employment generation and rapid economic growth in a sustainable manner. What is needed is risk finance and venture capital environment which can leverage innovation, promote technology and harness knowledge based ideas.*
- 1.2 *In the absence of an organised venture capital industry, individual investors and development financial institutions have hitherto played the role of venture capitalists in India. Entrepreneurs have largely depended upon private placements, public offerings and lending by the financial institutions. In 1973 a committee on Development of Small and Medium Enterprises highlighted the need to foster venture capital as a source of funding new entrepreneurs and technology. Thereafter some public sector funds were set-up but the activity of venture capital did not gather momentum as the thrust was on high-technology projects funded on a purely financial rather than a holistic basis. Later, a study was undertaken by the World Bank to examine the possibility of developing venture capital in the private sector, based on which the Government of India took a policy initiative and announced guidelines for venture capital funds (VCFs) in India in 1988. However, these guidelines restricted setting up of VCFs by the banks or the financial institutions only. Internationally, the trend favoured venture capital being supplied by smaller-scale, entrepreneurial venture financiers willing to take high risk in the expectation of high returns, a trend that has continued in this decade.*
- 1.3 *Thereafter, the Government of India issued guidelines in September 1995 for overseas venture capital investment in India. For tax-exemption purposes, guidelines were issued by the Central Board of Direct Taxes (CBDT) and the investments and flow of foreign currency into and out of India is governed by the Reserve Bank of India (RBI). Further, as a part of its mandate to regulate and to*



- develop the Indian capital markets, Securities and Exchange Board of India (SEBI) framed SEBI (Venture Capital Funds) Regulations, 1996.*
- 1.4 *Pursuant to the regulatory framework mentioned above, some domestic VCFs were registered with SEBI. Some overseas investment has also come through the Mauritius route. However, the venture capital industry understood globally as “independently managed, dedicated pools of capital that focus on equity or equity-linked investments in privately held, high-growth companies” (“The Venture Capital Cycle”, Gompers and Lerner, 1999) is relatively in a nascent stage in India. Figures from the Indian Venture Capital Association (IVCA) show that, till 1998, around Rs.30 billion had been committed by domestic VCFs and offshore funds which are members of IVCA [Not all overseas venture investors and domestic funds are members of the IVCA.] Figures available from private sources indicate that overall funds committed are around US\$ 1.3 billion. Investible funds are less than 50% of the committed funds and actual investments are lower still. At the same time, due to economic liberalization and increasing global outlook in India, there is increased awareness and interest of domestic as well as foreign investors in venture capital. While only 8 domestic VCFs were registered with SEBI during 1996-1998, an additional 13 funds have already been registered in 1999. Institutional interest is growing and foreign venture investments are also on the increase. Given the proper environment and policy support, there is tremendous potential for venture capital activity in India.*
- 1.5 *SEBI initiated interaction with industry participants and experts in early 1999 to identify the key areas critical for the development of this industry in India. The Finance Minister, in his 1999 budget speech had announced that “for boosting high-tech sectors and supporting first generation entrepreneurs, there is an acute need for higher investment in venture capital activities.” He also announced that the guidelines for registration of venture capital activity with the Central Board of Direct Taxes would be harmonized with those for registration with the Securities and Exchange Board of India. SEBI, decided to set up a committee on Venture Capital to identify the impediments and suggest suitable measures to facilitate the growth of venture capital activity in India. Keeping in view the need for a global perspective it was decided to associate Indian entrepreneurs from Silicon Valley in the committee. The committee is headed by K.B. Chandrasekhar, Chairman, Exodus Communications Inc., California, USA and consist of industry participants, professionals and the representatives from financial institutions and RBI. The list of the committee members is given in the **Annexure –I**.*
- 1.6 *The setting up of this committee was primarily motivated by the need to play a facilitating role in tune with the mandate of SEBI, to regulate as well as develop the market. The first meeting of the Committee took place on August 5, 1999 and followed by further deliberations by the Working Groups formed by the committee to examine the issues related to Structure and Fund Raising,*



Investment Process, Exit and Vision for the Venture Capital Industry in India. The draft recommendations of the committee were formulated in the meeting of the committee held on December 8, 1999. The draft recommendations were released for public comments and after considering the feed back, the report was finalised in the meeting of the Committee held on January 8, 2000.

2.0 OBJECTIVES AND VISION FOR VENTURE CAPITAL IN INDIA

2.1 Venture Capital funding is different from traditional sources of financing. Venture capitalists finance innovation and ideas which have potential for high growth but with inherent uncertainties. This makes it a high-risk, high return investment. Apart from finance, venture capitalists provide networking, management and marketing support as well. In the broadest sense, therefore, venture capital connotes risk finance as well as managerial support. In the global venture capital industry, investors and investee firms work together closely in an enabling environment that allows entrepreneurs to focus on value creating ideas and venture capitalists to drive the industry through ownership of the levers of control in return for the provision of capital, skills, information and complementary resources. This very blend of risk financing and hand holding of entrepreneurs by venture capitalists creates an environment particularly suitable for knowledge and technology based enterprises.

2.2 Scientific, technology and knowledge based ideas properly supported by venture capital can be propelled into a powerful engine of economic growth and wealth creation in a sustainable manner. In various developed and developing economies venture capital has played a significant developmental role. India, along with Israel, Taiwan and the United States, is recognized for its globally competitive high technology and human capital. The success India has achieved particularly in software and information technology of success against several odds such as inadequate infrastructure, expensive hardware, restricted access to foreign resources and limited domestic demand, is a pointer to the hidden potential it has in the field of knowledge and technology based industry. India has the second largest English speaking scientific and technical manpower in the world. Some of the management (IIMs) and technology institutes (IITs) are globally known as centres of excellence. Every year over 200,000 engineers graduate from Government and private-run engineering colleges. Many also specialise through diploma courses in computers and other technical areas. Management institutes produce 40000 management graduates annually. Given this quality and magnitude of human capital India's potential to create enterprises is unlimited.

2.3 In Silicon Valley, these very Indians have proved their potential and have carved out a prominent place in terms of wealth creation as well as credibility. There are success stories that are well known. They were backed by a venture capital environment in Silicon Valley and elsewhere in US which supports innovation and



invention. This also has a powerful grip over the nation's collective imagination. At least 30% of the start-up enterprises in Silicon Valley are started/backed by Indians. Back home also, as per NASSCOM data, the turnover of software sector in India has crossed Rs 100 billion mark during 1998. The sector grew 58% on a year to year basis and exports accounted for Rs 65.3 billion while the domestic market accounted for Rs 35.1 billion. Exports grew by 67% in rupee terms and 55% in US dollar terms. The strength of software professionals grew by 14% in 1997 and has crossed 160000. The global software sector is expected to grow at 12% to 15% per annum for the next 5 to 7 years. With the inherent skills and manpower that India has, software exports will thrive with an estimated 50% growth per annum. The market capitalisation of the listed software companies is approximately 25% of the total market capitalisation of around US\$ 200 billion as of December,1999. There is also greater visibility of the Indian companies globally. Given such vast potential which is not only confined to IT and software but also in several other sectors like biotechnology, telecommunications, media and entertainment, medical and health etc., venture capital industry can play a catalyst role in industrial development.

- 2.4 *It is important to recognise that while India is doing well in IT and software, it is still a low cost developer and service provider. Though it has the advantage of English-speaking, skilled manpower and cheap labour, its leadership is on a slipping edge as other countries such as Philippines, China and Vietnam are moving to occupy India's position as the premier supplier of low end software and support services. Many such countries have superior supplies of power, telecom and internet connections compared with India. As the US did in the semiconductor industry in the eighties, it is time for India to move to a higher level in the value chain. This will not happen automatically. The sequence of steps in the high technology value chain is information, knowledge, ideas, innovation, product development and marketing. Basically, India is still at the level of 'knowledge'. Given the limited infrastructure, low foreign investment and other transitional problems, it certainly needs policy support to move to the third stage i.e. ideas and towards innovation and product development. This is very crucial for sustainable growth and for maintaining India's competitive edge. This will need capital and other support which can be provided by venture capitalists.*
- 2.5 *India has a vast pool of scientific and technical research carried out in research laboratories, defense laboratories as well as in universities and technical institutes. A conducive environment including incubation facilities can help a great deal in identifying and actualizing some of this research into commercial production.*
- 2.6 *Development of a proper venture capital industry particularly in the Indian context is important for bringing to market high quality public offerings (IPOs). In the present situation, an individual investor becomes a venture capitalist of a*



sort by financing new enterprises and undertaking unknown risk. Investors also get enticed into public offerings of unproven and at times dubious quality. This situation can be corrected by venture capital backed successful enterprises accessing the capital market. This will also protect smaller investors. A study of US markets during the period 1972 through 1992 showed that venture-backed IPOs earned 44.6% over a typical five year holding period after listing compared with 22.5% for non-venture backed IPOs. The success of venture capital is partly reflected by these numbers since 80% of firms that receive venture capital are sold to acquiring companies rather than coming out with IPOs, in which the return multiple vis-à-vis non-venture funded companies is much higher. This potential can also be seen in sales growth figures for the U.S. where, from 1992 to 1998, venture capital funded companies sales have grown by 66.5% per annum on average versus 5% for Fortune 500 firms. The export growth by venture funded companies was 165%. All the top 10 sectors measured by asset and sales growth in USA were technology related.

- 2.7 Thus, venture capital is valuable not just because it makes risk capital available at the early stages of a project but also because of the expertise of venture capitalist that leads to superior product development. The big focus of venture capital worldwide is, technology. Thus, in 1999, around \$30 bn of venture capital has been invested in the U.S. of which technology firms reportedly got around 75%. Besides this huge supply from organised venture funds there is an even larger pool of “angel” funds provided by private investors. In 1999, it was expected that angel investment would be of the order of \$90 bn, thus making the total “at-risk” investment in high technology ventures in a single year of \$120 bn. By contrast, in India, cumulative disbursements to date are not more than \$500m, of which technology firms have received only 36%.
- 2.8 The other successful experience is that of **Taiwan**: Hsinchu Science-based Industrial Park is the showpiece of Taiwan’s success. Forty percent of the firms established in this government promoted park, which currently accommodate 3,000 expatriates, were begun by entrepreneurs from the United States. The revenue of firms located at Hsinchu Park alone was \$14 billion in 1998. Facilities at Hsinchu include English language teaching for the children of its expatriate entrepreneurs. The Hsinchu experiment has benefited from the generally high quality of education in Taiwan, whose institutes produce 50,000 engineers annually. Taiwan has 74 technical schools, 36 colleges and 24 universities, two of which are located near Hsinchu Park. The venture capital environment has also been a favorable factor. There are 110 venture capital firms in Taiwan, including 38 begun in 1998. By the end of 1997, these firms had invested \$1.32 billion in 1,839 ventures, mostly in high technology.
- 2.9 Taiwan’s government has been particularly successful in promoting its hardware industry through tax incentives, low tariff barriers, credit at cheap rates, good



- infrastructure facilities and establishment of research institutes. The Industrial Research Institute, owned by the government, started with semiconductor technology purchased from RCA Records. The technology subsequently developed at the Institute led to two very successful integrated chip firms. United Microland Corporation (UMC) and Taiwan Semiconductor Manufacturing Corporation (TSMC), which were initially promoted by the government and ultimately privatized.*
- 2.10. *Taiwan has benefited from close ties with Silicon Valley. A transnational community of Taiwanese venture capitalists has fostered a two-way flow of capital, skills and information between Silicon Valley and Taiwan. There is also an emerging trend of grouping of Taiwanese and Indian high technology talents in Silicon Valley. India can learn important lessons from the Taiwanese government's focus on education and encouragement of small enterprises, via facilities such as Hsinchu Park, as well as a U.S. – style legal, regulatory, tax, and institutional environment.*
- 2.11 *Similarly the venture capital industry in **Israel** has grown from one firm with a corpus of \$30 million in 1991, to eighty firms with a corpus of \$3 billion by 1998. Further, Israel's IT speciality is developing technology rather than software or products. This focus has meant that new Israeli ventures are most typically acquired by larger technology firms, and IPO route in the U.S. markets has also been successful. In fact, Israeli companies are the second largest group of companies listed on the Nasdaq markets after American companies, a remarkable achievement for a country of 6 million persons.*
- 2.12 *Like Taiwan, Israel is another country in which government policy fostered a successful, highly diversified, self-reliant industry. In the early 1990s, Israel restructured its legal, accounting and regulatory framework to mimic that of the United States. The new Israeli framework guarantees U.S. investors parity with U.S. tax rates. In 1984, the Israeli government passed a law to encourage industrial research and development (R&D) and created the Office of the Chief Scientist to implement government policy related to this area. The law's strategy is to encourage private companies to invest in R&D projects with the government sharing the business risk. Under the law, a Research Committee appointed by the Chief Scientist approves proposals for anywhere from 30 to 66 percent of given projects' funding (up to \$250,000). These proposals, when funded, also receive tax exemptions for up to ten years. As an additional incentive to entrepreneurship, the Israeli government has created twenty six technology incubators designed to allow start-ups to convert their ideas into commercially viable products.*
- 2.13 *Israel's government participates in international cooperation, seeking to match the nation's technical skills with global markets, and to share start-up risks up front with later-stage activities such as marketing. The most successful of these*



- ventures has been the Bilateral Industrial Research and Development Foundation (BIRD), a joint venture with the U.S. government. The Israeli high technology industry enjoys the same kinds of transnational ties that has helped Taiwan. Similarly, the Israeli venture capital industry has strong U.S. connections. Several of Israel's experiences have relevance for India. Government policy on incubators, the funding of R&D projects, and the BIRD project provide useful object lessons for the Indian government and business alike.*
- 2.14 *Venture capital has played a very important role in U.K., Australia and Hong Kong also in development of technology growth of exports and employment.*
- 2.15 *India certainly needs a large pool of risk capital both from home and abroad. Examples of US, Taiwan and Israel clearly show that this can happen provided there is right regulatory, legal, tax and institutional environment. It is also necessary that start-up's have access to R&D flowing out of laboratories and universities with infrastructure support such as telecom, technology parks etc. Steps are being taken at the level of Government, Ministry of Information and Technology, and CSIR for improvement in infrastructure and R&D. Certain NRI organisations are taking initiatives to create a corpus of US\$500m to strengthen the infrastructure of IITs. More focused attempts will be required in all these directions.*
- 2.16 *Recent phenomena, partly ignited by success stories of Indians in US and other places abroad, provide the indications of a growing number of young, technically qualified entrepreneurs in India. There are success stories within India also. At the same time increasing number of internationally savvy, senior managers have been leaving established multinationals and Indian companies to start new ventures. The quality of enterprise in India is on an ascending curve. The atmosphere thus is ripe for creating the right regulatory and policy environment for sustaining the momentum for high-technology entrepreneurship. The Indians abroad have leapfrogged the value chain of technology to its highest levels. By bringing venture capital and other supporting infrastructure this can certainly happen at home also.*
- 2.17 *Another important area is the need for multi country integration. Information Technology and Internet have brought about the trend of what can be called the "death of distance" and operation across the countries can be seamlessly integrated. In the Indian context with developing IT and internet technology coupled with close linkages of Indian technocrats and entrepreneurs located in India and abroad, there are interesting possibilities. This will of course need further regulatory and policy support to provide operational flexibility, easy entry-exit and ownership patterns to suit global needs. It is also to be noted that the quality and quantity of research conceptualized in startups competes*



favorably with research undertaken by big firms. This phenomenon is seen even in India.

- 2.18 *What could all this mean in terms of employment generation within India? There is probably no industry as employment intensive in productivity and numbers as high technology. In US venture funded companies have grown jobs by 40% per annum since 1992. Conversely Fortune 500 jobs shrank by 2.5% per annum during the same period. 60% of the jobs created by venture funded companies were engineers/skilled jobs. Further in 62% of the venture funded companies, stock options covered 100% of the employees. India today produces over 60000 new computer science graduates annually and over 2 lakh more enroll annually in computer training institutes. Besides, about 200,000 engineering graduates come out from engineering colleges in addition to the substantial number of persons doing diploma and certificate courses in technology related areas. By contrast, in Taiwan, the total number of engineering graduates is around 50000 and in US it is 30000 per annum. According to available estimates there are about 3,50,000 unfilled jobs of computer scientists in the US with the growth rate of 100,000 job requirement each year. Achieving even a reasonable fraction of US scale of development in information technology and other knowledge based areas, there is going to be a big employment generation in India. Additionally, given India's lower labour cost, the potential for employment is even larger than what appears from these estimates.*
- 2.19 *It also needs to be noted that with other areas of business and industry getting more and more technology oriented, there will be requirement of jobs all around. Indications are already emerging, as firms in India which are being outsourced by foreign organisations to provide services are recruiting hundreds of employees within one year of their existence. Several such firms are getting located around Delhi, Bangalore and Hyderabad. With proper venture capital support, there can be a phenomenal increase in start-up enterprises which would generate further employment potential.*
- 2.20 *Given the right environment, large flows of risk finance and venture capital can flow into the country. Apart from the foreign investment, substantial venture capital is likely to come from overseas Indian community in Silicon Valley. This is particularly so as some of the Indian technocrat entrepreneurs in Silicon Valley have strong Indian linkages at professional level and are enthused to invest in India. There are at least 300 such entrepreneurs with individual wealth exceeding \$5 million and total wealth of about \$25 US billion. Another 1000 are believed to have wealth in the range of \$ 1-5 million. Currently, about 20% of their wealth is reinvested in new ventures which will rise as vesting schedules mature. The risk capital with Indian entrepreneurs is around \$6 billion and even if 15% to 20% comes to India annually, there is a ready pool of around \$1 billion available for annual venture capital investment in India. Further, larger*



venture capital firms in the United States with a combined corpus of around US\$ 35 billion have reportedly set aside upto 20% of their funds for investment offshore. India along with Ireland and Taiwan, is a favoured destination for investments by these offshore venture funds.

- 2.21 *The net FII investment in Indian markets is around US \$10 billion and the flows for the last few years have generally been positive. With enhanced interest in India as compared to some of the other emerging and Asian markets, given the right environment good amount of money would flow as venture capital investment. This is more so because India has already acquired credibility particularly in the area of information technology and sectors like media, pharmaceuticals etc. While the proportion of offshore to local capital which is around 80% foreign and 20% domestic, may remain same for the first few years, the recycling of entrepreneurial wealth and skills within the industry will gradually lead to greater presence of domestic venture capital industry .*
- 2.22 *With this background India is rightly poised for a big leap. This can happen by creating the right environment and the mind set to understand global forces and when that happens we would have created not “Silicon Valley” but the “Ind Valley” a phenomena for the world to watch and reckon with .*

3.0 CRITICAL FACTORS FOR SUCCESS OF VENTURE CAPITAL INDUSTRY

- 3.1 *Getting it right is what this report is concerned about. The endeavor of the Committee has been to make recommendations that will facilitate, through an enabling regulatory, legal, tax and institutional environment, the creation of a pool of risk capital to finance start-up enterprises with the underlying objective of helping India achieve: a) rapid economic growth and b) integration with the global economy from a position of strength.*
- 3.2 *While making the recommendations, the Committee 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 . This also underscores the facilitating and promotional role of regulation. Internationally, venture funds have evolved in an atmosphere of structural flexibility, fiscal neutrality and operational adaptability. We need to provide regulatory simplicity and structural flexibility on the same lines. There is also the need for a level playing field between domestic and offshore venture capital investors. This has already been done for the mutual fund industry in India.*



- *Investment, management and exit should provide flexibility to suit the business requirements and should also be driven by global trends. Venture capital investments have typically come from high net worth individuals who have risk taking capacity. Since high risk is involved in venture financing, venture investors globally seek investment and exit on very flexible terms which provides them with certain levels of protection. Such exit should be possible through IPOs and mergers/acquisitions on a global basis and not just within India.*
- *There is also the need for identifying and increasing the domestic pool of funds for venture capital investment. In US, apart from high net worth individuals and angel investors, pension funds, insurance funds, mutual funds etc provide a very big source of money. The share of corporate funding is also increasing and it was as high as 25.9% in the year 1998 as compared to 2% in 1995. Corporations are also setting up their own venture capital funds. Similar avenues need to be identified in India also.*
- *With increasing global integration and mobility of capital it is important that Indian venture capital firms as well as venture financed enterprises be able to have opportunities for investment abroad. This would not only enhance their ability to generate better returns but also add to their experience and expertise to function successfully in a global environment. We need our enterprises to become global and create their own success stories. Therefore, automatic, transparent and flexible norms need to be created for such investments by domestic firms and enterprises.*
- *Venture capital should become an institutionalized industry financed and managed by successful entrepreneurs, professional and sophisticated investors. Globally, venture capitalist are not merely finance providers but are also closely involved with the investee enterprises and provide expertise by way of management and marketing support. This industry has developed its own ethos and culture. Venture capital has only one common aspect that cuts across geography i.e. it is risk capital invested by experts in the field. It is important that venture capital in India be allowed to develop via professional and institutional management.*
- *Infrastructure development also needs to be prioritized using government support and private management. This involves creation of technology as well as knowledge incubators for supporting innovation and ideas. R &D also needs to be promoted by government as well as other organisations.*

The recommendation of the Committee are discussed and enumerated in the paragraphs hereafter.



4.0 MULTIPLICITY OF REGULATIONS – NEED FOR HARMONISATION AND A NODAL REGULATOR

4.1 *At present, the Venture Capital activity in India comes under the purview of different sets of regulations namely :*

- (i) *The SEBI (Venture Capital Funds) Regulation, 1996[Regulations] lays down the overall regulatory framework for registration and operations of venture capital funds in India.*
- (ii) *Overseas venture capital investments are subject to the Government of India Guidelines for Overseas Venture Capital Investment in India dated September 20, 1995.*
- (iii) *For tax exemptions purposes venture capital funds also needs to comply with the Income Tax Rules made under Section 10(23FA) of the Income Tax Act.*

4.2 *In addition to the above, offshore funds also require FIPB/RBI approval for investment in domestic funds as well as in Venture Capital Undertakings(VCU). Domestic funds with offshore contributions also require RBI approval for the pricing of securities to be purchased in VCU likewise, at the time of disinvestment, RBI approval is required for the pricing of the securities.*

4.3 *The multiple set of Guidelines and other requirements have created inconsistencies and detract from the overall objectives of development of Venture Capital industry in India. All the three set of regulations prescribe different investment criteria for VCFs as under :*

- *SEBI regulations permit investment by venture capital funds in equity or equity related instruments of unlisted companies and also in financially weak and sick industries whose shares are listed or unlisted. The Government of India Guidelines and the Income Tax Rules restrict the investment by venture capital funds only in the equity of unlisted companies.*
- *SEBI Regulations provide that atleast 80% of the funds should be invested in venture capital companies and no other limits are prescribed. The Income Tax Rule until now provided that VCF shall invest only upto 40% of the paid-up capital of VCU and also not beyond 20% of the corpus of the VCF. The Government of India guidelines also prescribe similar restriction. Now the Income Tax Rules have been amended and provides that VCF shall invest only upto 25% of the corpus of the venture capital fund in a single company.*
- *SEBI Regulations do not provide for any sectoral restrictions for investment except investment in companies engaged in financial services. The Government of India Guidelines also do not provide for any sectoral restriction, however, there*



are sectoral restrictions under the Income Tax Guidelines which provide that a VCF can make investment only in companies engaged in the business of software, information technology, production of basic drugs in pharmaceutical sector, biotechnology, agriculture and allied sector and such other sectors as notified by the Central Government in India and for production or manufacture of articles or substance for which patent has been granted by National Research Laboratory or any other scientific research institution approved by the Department of Science and Technology, if the VCF intends to claim Income Tax exemption. Infact, erstwhile Section 10(23F) of Income Tax Act was much wider in its scope and permitted VCFs to invest in VCU's engaged in various manufacture and production activities also. It was only after SEBI recommended to CBDT that atleast in certain sectors as specified in SEBI's recommendations, the need for dual registration / approval of VCF should be dispensed with, CBDT instead of dispensing with the dual requirement, restricted investment to these sectors only. This has further curtailed the investment flexibility.

- 4.4 *The Income Tax Act provides tax exemptions to the VCFs under Section 10(23FA) subject to compliance with Income Tax Rules. The Income Tax Rules inter alia provide that to avail the exemption under Section 10(23FA), VCFs need to make an application to the Director of Income Tax (Exemptions) for approval. One of the conditions of approval is that the fund should be registered with SEBI. Rule 2D also lays down conditions for investments and section 10(23FA) lays down sectors in which VCF can make investment in order to avail tax exemptions. Once a VCF is registered with SEBI, there should be no separate requirement of approval under the Income Tax Act for availing tax exemptions. This is already in practice in the case of mutual funds.*
- 4.5 *The concurrent prevalence of multiple sets of guidelines / requirements of different organisations has created inconsistencies and also the negative perception about the regulatory environment in India. Since SEBI is responsible for overall regulation and registration of venture capital funds, the need is to harmonise and consolidate within the framework of SEBI Regulation to provide for uniform, hassle free, one window clearance. A functional and successful pattern is already available in this regard in the case of mutual funds which are regulated through one set of regulations under SEBI Mutual Fund Regulations. Once a mutual fund is registered with SEBI, it automatically enjoys tax exemption entitlement. Similarly, in the case of FIIs tax benefits and foreign inflow/ outflow are automatically available once these entities are registered with SEBI.*
- 4.6 *It is therefore necessary that there is a single regulatory framework under SEBI Act for registration and regulation of VCFs in India. It may be mentioned that Government of India Guidelines were framed on September 20, 1995 and SEBI regulations were framed in 1996 pursuant to the amendment in the SEBI Act in*



1995 giving SEBI the mandate to frame regulations for venture capital funds. After the notification of SEBI regulations, separate GOI Guidelines for venture investments should have been repealed. Further, once a VCF including the fund having contribution from off shore investors, is registered with SEBI, the inflows and outflows of funds should be under transparent automatic route and there should be no need for separate FIPB / RBI approvals in the matters of investments, entry / exit pricing. Likewise, VCF once registered with SEBI should be entitled for automatic tax exemptions as in the case of mutual funds. Such single regulatory requirement would provide much needed investment and operational flexibility, make the perception of foreign investors positive and create the required environment for increased flow of funds and growth of the venture capital industry in India.

- 4.7 SEBI regulations provides flexibility in selection of investment to the VCF, however, in the event of subscription to the fund by an overseas investor or the fund choosing to seek income tax exemptions, the investment flexibility is curtailed to a great extent. It is worth mentioning that one of the condition for grant of approval under the Income Tax Rules for seeking exemption under the Income Tax Act is that the fund should be registered with SEBI which make it obligatory on the venture capital fund not only to follow Income Tax Rules but also the SEBI Regulations. Further, a VCF has to seek separate registration under the SEBI Act and approval under the Rules of Income Tax apart from seeking approval from FIPB / RBI in the event of subscription to the fund by an overseas investor.

4.8 **RECOMMENDATIONS**

In the above background, following recommendations are proposed:

- (a) *Since SEBI is responsible for registration and regulation of venture capital funds, the need is to harmonise and consolidate multiple regulatory requirements within the framework of SEBI regulations to provide for uniform, hassle free, single window clearance with SEBI as a nodal regulator.*
- (b) *In view of the (a) above, Government of India may consider repealing the Government of India – MoF(DEA) Guidelines for Overseas Venture Capital Investment in India dated September 20, 1995*
- (c) *The Foreign Venture Capital Investor (FVCI) should registered under the SEBI Regulations under the pattern of FIIs.*
- (d) *For SEBI registered VCF, requirement of separate rules under the Income Tax Act should be dispensed with on the pattern of mutual funds.*



5.0. TAX PASS THROUGH FOR VENTURE CAPITAL FUNDS

- 5.1 *Internationally, VCFs being dedicated pools of capital, operate in fiscal neutrality and are treated as pass through vehicles. In any case, the investors of VCFs and VCUs are subject to income tax. Through a series of changes in the Tax Laws, a distinct fiscal frame work has already been created over the last decade, for taxation of Mutual Funds. The fiscal regime for mutual funds quite simply eliminated the tax at the pool level while maintaining taxation at the investor level. Thereby it avoided double taxation of the same stream of income of an unincorporated pool and concomitantly maintained single tax at investor level. The objective behind is to provide fiscal neutrality as the income is taxed in the hands of final recipient and intermediary body is considered a pass through entity. Drawing the same analogy, a Venture Capital Fund is also a pool of funds of investors and income of the fund should be taxed in the hands of the investor and the fund should be considered a pass through entity and exempt under the income tax. Under the present regime, income of a VCF is taxable at fund level, (except for the exemption provided under section 10(23 FA) of the Income tax act for the income by the way of dividend and capital gains) and also taxable in the hands of investors when distributed by VCF. Pre-empting dual level (pool, as well as investor level) taxation has been a hallmark of Indian Income Tax Legislation for decades. It is therefore recommended that the present Section 10(23FA) be reenacted such that it provides complete exemption from income tax at fund level on the basis of SEBI Registration (like in the case of mutual funds). Exempting the VCF from income tax does not necessarily cause the loss of revenue as these are pass through entities and income distributed by VCF would be taxed in the hand of investors. Further, such pass through income would not just include dividends only, but also capital gains and interest income. In most of the cases, the bulk of income pass through would be in the nature of capital gains which attract tax in contrast to the income passed through as dividend. This would therefore increase the country's tax base without any negative effect on the revenues.*
- 5.2 *In addition, venture capital activities aid to the growth of industrial activity, which would indirectly add to the tax payers base. Global experience shows that venture funded enterprises have created more wealth and consequent tax revenues. It is certainly believed that in India also, with the active venture capital funding, there would be a very large number of successful enterprises which would add to the national wealth creation including the tax revenues.*



5.3 **RECOMMENDATIONS**

In the above background, following recommendations are proposed :

(a) The existing section 10(23FA) of Income Tax Act needs to be re-enacted to provide for automatic income tax exemption to VCFs registered with SEBI (like in the case of mutual funds) which will eliminate the taxation at the pool level while maintaining the same at investor level. The new Income tax Section 10(23FA) would then read as under :

“Any income of a registered venture capital fund under the Securities and Exchange Board of India Act 1992 or Regulations made thereunder”.

Consequently, no separate rules as in 2D would be needed.

6. MOBILISATION OF GLOBAL AND DOMESTIC RESOURCE

6.1 Foreign Venture Capital Investors(FVCIs)

6.1.1 At present, offshore investors make investment in VCU either by investing in domestic venture capital funds by seeking one time approval from FIPB through FDI route directly. However, this requires FIPB approval for every single investment. Further, for every investment and disinvestment, RBI approvals are required in respect of pricing of securities. The Government of India guidelines provide for one time FIPB approval in the case of venture capital fund with 100% investment by offshore investors, but in practice, requirement of taking approval for pricing of securities from RBI remains for every investment and disinvestment. Foreign investors find the requirements of taking FIPB/RBI approvals very cumbersome and time consuming.

6.1.2 Most of the offshore investors are incorporated in tax havens particularly Mauritius to have the benefit of double tax treaty and they do not have an incidence of tax in India. These investors feel that if making investment in India is made hassle free and automatic in a transparent manner with proper tax exemptions, there would be no need for them to adopt Mauritius route and avoid several operational problems. FVCIs therefore shall be provided tax exemptions. This provision will put all FVCIs, whether investing through Mauritius route or not, on the same footing.

6.1.3 Realising the importance of venture capital investments for the development of industry and business in India, it is necessary that inflow of such investments are encouraged and facilitated. In case of FIIs there is already a hassle free and automatic route for investment and repatriation without specific FIPB/RBI approval for investments and disinvestments. Once registered with SEBI, FIIs



can freely make investments. This has brought positive investment and the net investment are around US\$10 billions. It would therefore, be desirable that atleast at par with FIIs. FVCIs are allowed the facility of registration with SEBI and once registered they should have the same facility of hassle free investments without any requirement of approvals from FIPB/RBI. This would also provide authentic data and disclosures as regards their commitments and investments in VCU in India. Presently, as per Annexure III of the Industrial Policy 1991, there are already several sectors which are eligible for the investment under automatic approval route varying from 50% to 100% of the paid up capital of the companies. In case of NRIs and OCBs this limit is 100%. Keeping this in view and venture capital being a thrust area for attracting risk finance for development of business and industry, 100% inflow of funds of the foreign venture capital investors should be allowed through automatic approval route without requiring either FIPB/RBI approval once registered with SEBI. Appropriate regulatory requirements in respect of FVCIs could be incorporated under SEBI venture capital funds regulations. Alternatively, FVCIs should be allowed to invest within overall ceiling of 50% of the paid up capital of the investee company under automatic route. However, the ceiling of 50% would get substituted by higher ceilings of 51%, 74% and 100% in respect of the sectors as provided in annexure III of the Statement of Industrial Policy and would get decreased accordingly wherever Government of India has prescribed lower ceiling as in the case of insurance, banking sector etc. This proposal is consistent with the existing policy of Government of India as regards automatic approvals.

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

- (iv) Venture capital is a high risk area. In out of 10 projects, 8 either fails or yield negligible returns. It is therefore in the interest of the country that FVCIs bear such a risk.*
- (v) For venture capital activity, high capitalisation of venture capital companies is essential to withstand the losses in 80% of the projects. In India, we do not have such strong companies.*
- (vi) The FVCIs are also more experienced in providing the needed managerial expertise and other supports.*

6.1.5 Further, the FVCI bringing in foreign currency should be permitted to retain the same in foreign exchange either with the Bank in India or outside till it is actually invested. Further, as permitted in the case of FIIs they may be permitted to take forward cover to protect against the currency, price fluctuation risk.



6.1.6 Recommendations

In view of the above background, following recommendations are proposed :

- a) SEBI regulations should be amended to include provisions for registration and regulation of Foreign Venture Capital Investor(FVCI) on the pattern of FIIs and once registered, should be extended .the same facility of hassle free investment and disinvestment without any approval from FIPB/RBI.*
- b) Foreign VC Investor (FVCI), registered with SEBI would be eligible to make venture capital investments under automatic route without any ceiling and any requirement of FIPB or RBI approval or alternatively, in the overall ceiling of 50% in any sector under automatic route without FIPB/RBI approval provided the overall ceiling would automatically get substituted by higher ceiling of 51%,74% and 100% as prescribed under Annexure III of Statement of Industrial Policy or will get reduced in accordance with the ceilings for investment prescribed by Government of India in certain specified sectors like banking, insurance etc.*
- c) The FVCI should be permitted to park their foreign remittances in foreign exchange in a bank in India or outside till actually invested in VCUs and they should also be permitted to obtain forward cover as permitted to FIIs.*
- d) The Government may consider providing a tax exemption to registered FVCI to attract large pool of risk capital directly into India.*

6.2 Augmenting the Domestic pool of Resources

6.2.1 The present pool of domestic venture capital and commitments made by FVCIs is around US\$ 1.3 billion. This pool has been predominantly contributed by foreign funds to the extent of 80%. The domestic pool of venture capital is very limited. The acute need for venture capital in India is for small and medium industries which could preferably be financed by domestic venture capital funds, as the foreign funds, seek to invest in relatively larger enterprises and the return expectations are also high. The main sources of contribution for domestic venture capital funds are from financial institutions, banks, high networth individuals, etc. The venture capital activity needs to be deep rooted to promote a small and medium scale industries promoted by professionally qualified entrepreneurs in hi-tech, research oriented sectors. It is therefore necessary to augment the pool of resources for domestic venture capital funds.

6.2.2 The investment horizon of a venture capital fund is for a longer duration ranging from five to ten years and the funds are contributed mainly by the institutional investors and high networth individuals. Typically, the institutional investors include Banks, financial institutions, Insurance Companies, Pension Funds, Private Trusts, Endowments and angel investors which in case of India are yet not active into venture capital industry. The expected role of banks, mutual funds and



insurance companies in promotion of venture capital activity in India is discussed hereunder :

- 6.2.3 **Banks:** *RBI had recently allowed banks to invest in Venture Capital funds with a provision that this investment could be treated as priority sector lending. In order to encourage the banks to provide venture capital to start up industries, the RBI should treat venture financing by banks under the priority sectors lending to small scale industries. The investments made by Banks in venture Capital Funds/Undertakings directly or through subsidiaries, should not be counted for the purpose of 5% exposure to the capital market. Further, Banks should be encouraged to extend line of credit to Venture Capital Funds.*
- 6.2.4 **Mutual Funds:** *The Mutual Fund industry is fast becoming a channel for routing private savings into capital market. Given that an appropriate regulatory framework for Mutual Funds is in place, it would be desirable that the mutual funds are permitted to invest upto 10% of their corpus in SEBI registered Venture Funds. Within this ceiling, individual Mutual Funds may have their own prudential limits. This would also give the opportunity to retail investors to participate in high growth enterprises through the institutional mechanism of mutual funds. Further, Mutual Funds can set up a dedicated fund for investment in VCF / VCU.*
- 6.2.5 **Insurance Companies:** *Insurance companies typically accumulate large pools of capital which is available for investment on a long-term horizon. If such funds are deployed in venture capital industry, these may not only generate good return to the insurance company, at the same time, would provide significant resources to the venture capital industry. Insurance companies may be permitted to invest in SEBI registered Venture capital Funds within certain ceilings.*
- 6.2.6 *It is seen in many developed and developing countries that the entry of institutional players not only boosted resource mobilisation for venture capital activity but also over a period of time, these institutional investors become expert assessors of the investment activities of Funds and provides appropriate business guidance, as happened in USA. Thus, these investors not only provide large resources for venture capital activity, but also help in developing appropriate system for monitoring the investment by VCF.*
- 6.2.7 **RECOMMENDATION**
- (a) *In the light of the above it is recommended that the mutual fund, banks and insurance companies should be permitted to invest in SEBI registered venture capital funds.*



7.0 FLEXIBILITY IN INVESTMENT AND EXIT

7.1 Allowing Flexible Structure

- 7.1.1 *The venture capital fund is a high risk and reward activity. The investments are made by high networth individuals and institutions to reap high returns. The investor in venture capital funds does not involve himself in day-to-day management of the fund and the activities of the funds are managed by professionals. The investor therefore likes to keep their liability limited to the contribution committed by them to the fund and are not willing to take on any other liability. The venture capital funds are set up for a limited life and on maturity, the returns are distributed amongst the investors. The structure of venture capital funds should therefore protect the interest of investors and the liquidation process should be simple. Limited Partnership(LP), Limited Liability Partnership(LLP) and the Limited Liability Company(LLC) are commonly used and widely accepted structures internationally especially in USA which has an active venture capital industry. These structures limit the liability of investors to the extent of funds committed, at the same time they can be structured to become pass through vehicles for the purpose of income tax. The legal structure of LP, LLP and LLC is enclosed as Annexure to the Report.*
- 7.1.2 *For venture capital funds which deal in high risk investments structuring flexibility is very important to meet their business strategies. In India, such structures like LP, LLP and LLC are not recognised under the Indian Partnership Act and the Indian Companies Act. For development of VC industry in India on global lines and also to facilitate and attract the foreign investment in venture capital industry, such alternative structures need to be provided by bringing appropriate changes in legislation.*
- 7.1.3 *Under the SEBI Regulations a VCF can be registered in the form of a Trust, a Company or a Body Corporate(with a recent amendment dated November 17, 1999 under the Regulations). A company or a body corporate registered with SEBI may float multiple schemes for investment in different categories of companies and the fund set up as trust may also establish one or more funds under it. SEBI Regulations however, do not specifically provide for registration of a scheme floated by a body corporate or a company, as like mutual fund schemes and multiple funds set up by a venture capital fund incorporated as a trust. At present, the LP, LLP and LLC structure are also not permitted under the statutes ie. the Indian Partnership Act and the Indian Companies Act However, as and when permitted, these should be eligible to be registered under the SEBI Regulations. The SEBI regulation therefore needs to be amended to provide for registration of other entities such as LP, LLP, LLC, etc as well as the scheme*



floated by or the fund setup by a Trust, Body Corporate, Company and other entities.

7.1.4 Recommendations

In view of the above background the following recommendations are proposed:-

- (a) The necessary legislative provisions for incorporation of entities such as Limited Partnership(LP), Limited Liability Partnership(LLP), Limited Liability Company(LLC) may be made by way of enactment of separate Act or by way of amending the existing Indian Partnership Act and Indian Companies Act.*
- (b) SEBI Regulations should be amended to include the eligibility for registration of other entities such as LP, LLP, LLC, etc. as and when permitted to be incorporated under the respective statutes.*
- (c) SEBI Regulation should be amended to include a provision for registration of scheme floated or funds set up by a Trust, Company, Body Corporate or any other entity.*
- (d) The Indian Companies Act be amended so as to permit issue of shares by unlisted limited companies with differential right in regard to voting and dividend. Such a flexibility already exists under the Companies Act in the case of private companies which are not subsidiary of public limited companies.*

7.2 Flexibility in the matter of investment ceilings and sectoral restrictions

7.2.1 Venture capital Investments falls under high risk category of investment and typically it comes from high networth sophisticated and long term investors and institutions. The basic dictum in VC investments therefore is that "Money finds its best use" as the investors and fund managers are expected to be expert, sophisticated and fully aware of the risk / return potentials. Unlike several other type of investments, venture capitalists provide fund to build up resources and enterprises. Because of the very nature of VC investment and type of investors involved, a high degree of flexibility in terms of selection of investment, instruments and terms of investment is required. Internationally also, venture capital industry has developed in an environment which provides such investment flexibilities.

7.2.2 In the present regulatory requirements, there are sectoral restrictions as well as various types of investment ceilings. Sectoral restrictions for investment by VCFs are not consistent with the very concept of venture in promotion of innovation and

technology as innovation and technology based ideas could emerge in any area of business, manufacturing or services. The function of VCFs is to provide risk capital and support idea based enterprises. All over the world, specially in countries like USA, Israel, Taiwan, Malaysia, Australia, etc venture capital funding has gone to business, service as well as manufacturing and helped the growth in all these sectors. Selectivity comes in the very nature of VC funding which comes from high networth, sophisticated individual and institutional investors who know where to put their money to its best use. It is therefore strongly believed that sectoral restrictions crate unnecessary obstacles and hamper the growth of VC activity. However, certain restrictions could be put by specifying a negative list which could include areas like real estate, finance companies, activities not legally permitted and any other sectors which could be notified with SEBI in consultation with the Government. Infact, the present SEBI regulations as well as Government of India Guidelines do not have any such restrictions and restrictions have been put under the Income Tax Act for tax exemption purposes only. However in view of the discussion in the earlier chapter and the proposed recommendation therein that as in the case of mutual funds, once registered with SEBI, VCF could be automatically entitled to tax exemption and no separate rules under the Income Tax Act would be required.

- 7.2.3 *The investment criteria under the SEBI regulations prescribe that at least 80% of the funds raised by VCF should be invested in unlisted or financially weak sick companies. The Income Tax Rules and the Government of India Guidelines for overseas venture capital investment until recently prescribe a ceiling of 40% of paid up capital of an investee company and not beyond 20% of the corpus of the fund. These investment restrictions can seriously affect the flexibility in operation of venture capital fund. The venture funds may engineer a turnabout by increasing their stake in an investee firm and restructuring the management. During these times, the restriction of investing only upto 40% of the paid up capital of the company will be a major constraint. Similarly, if the performance of investee companies are below expectation, the VCF may choose to withhold further release of funds into the investee companies which may violate the minimum 80% investment limit under SEBI Regulation. It is therefore felt that VCFs should have flexibility of investment depending upon the business requirement in start up companies. Further, the ceiling of investment of not more than 25% of the corpus of the VCF in one single investee company would meet the requirement of diversification of risk of VCFs. Here it may be noted that globally VCFs invest in sufficient number of investments which is part of the investment strategy. However in the Indian context and since VC industry is still in the evolutionary stage, it would be desirable to keep the ceiling of 25% of the corpus for investment in single VCU. Further, VCF should not be permitted to invest in associated companies. No other investment ceilings including 80% limit for investment as provided in SEBI Regulations are appropriate in VC operations.*



Manner and nature of investments should be disclosed by VCFs as a part of their investment strategy statement.

7.2.4 The SEBI Regulation restricts the investment by VCF in unlisted equity or equity related instruments and listed securities of financially weak or sick companies. The Government of India Guidelines and the Income Tax Rules restrict the investment only in unlisted equity of the investee company. The venture capital fund need to enter into structured deals and the deals may also include the options for venture capital funds to buy or sell the equity of the investee company on occurrence of particular event. Sometimes, the VCFs require to invest partly in debt also. Such flexibilities of investment instruments are not available to VCF in India in view of the Government of India Guidelines and CBDT Guidelines as well as to some extent under SEBI Regulations also. Therefore, while primarily the VCFs should be investing in unlisted equity only, there should be flexibility to invest in listed equity though with a reasonable ceiling. Further, the investment in listed equity should be restricted through the initial public offer of a company whose shares are proposed to be listed or through a preferential offer in the case of a company which is already listed. Similarly, in certain situations, VCFs are required to provide debt also to the undertakings where they have already made VC investment. Thus the investment other than unlisted equity may be permitted within the overall ceiling of 30% of the investible fund and atleast 70% should be invested in unlisted equity, equity related instruments or other instruments convertible into equity. This is keeping in tune with the funding patterns of VCFs globally.

7.2.5 In USA, the investment by VCFs are done as subscription to preferred stock (similar to preference share in terms of dividend and liquidation) with preferential voting /veto rights in respect of key decisions like modification in the Memorandum and Article of Association, expansion or sale of whole or part of business, merger or acquisition, etc. The preferred stock is convertible into equity shares at the option of venture capital investors. In order to facilitate investment by VCF in new enterprises, the Companies Act may be amended so as to permit issue of shares by unlisted public companies with a differential right in regard to voting and dividend. Such a flexibility already exists under the Indian Companies Act in the case of private companies which are not subsidiaries of public limited companies.

7.2.6 The venture capitalists invest into long term high risk portfolios to create wealth. FIIs invest money with a shorter outlook and time frame which may add to speculation and volatility in the capital market. On the other hand, investment by venture capitalists are long term investments and contribute to the building of enterprises and promotion of industrial and business activity. The venture capital investors therefore in no way should be put to more restrictions as compared to FIIs. On the contrary, such investment should be encouraged and facilitated



through regulatory support. The FVCI needs to obtain approval for pricing from RBI at the time of investment as well as disinvestment. However, when FIIs invest in unlisted equity stocks, they are not required to obtain such approvals. In addition to this, the formula applied for arriving at the prices of unlisted securities based on book value and PE multiples of BSE National Index are extremely restrictive and not in tune with the valuations relevant to the new generation enterprises which typically obtain VC funding like in infotech, biotech, service industries, etc. Such enterprises especially start up enterprises do not have tangible assets but the stock of the same may obtain high valuations due to their intangible assets like human resources, growth prospects, etc. Therefore, once foreign venture capital investor either coming through 100% funding in a domestic VCF or otherwise registered with SEBI should not be subjected to such requirements.

7.2.7 Recommendations:

In the above background, the following recommendations are proposed:

- (a) Investments by VCFs in VCUs should not be subject to any sectoral restrictions except those to be specified as a negative list by SEBI in consultation with the Government which may include areas like real estate, finance companies and activities prohibited by Law.*
- (b) There is no need for any ceiling of investment in equity of a company. It is understood that the investment ceiling of 40% of paid up capital of VCU under the Income tax Act has already been removed. As a prudential norm, the investment in one VCU should not exceed 25% of the corpus of VCF..*
- (c) The investment criteria needs to be amended to provide for investment criteria whereby VCF invest primarily in unlisted equity and partly in listed equity, structured instruments or debts also. The investment in listed equity shall be through IPO or preferential offer and not through the secondary market route. The VCF shall invest atleast 70% of the investible funds in unlisted equity of VCU and 30%of investible funds may be used for investment through IPO, preferential offer, debt, etc. The investible funds would be net of expenditure incurred for administration and management of the funds. The present requirement of investment of atleast 80% of the funds raised by the VCF under the SEBI Regulations needs to be replaced by the criteria as under:
 - (i) The VCF will disclose the investment strategy at the time of application for registration.**



- (ii) *The VCF shall not invest more than 25% of the corpus in one VCU and shall not invest in an associated concern.*
- (iii) *The VCF will make investment in the venture capital undertakings as enumerated below :*

 - (1) *atleast 70% of the investible funds shall be invested in unlisted equity shares or equity related instruments or other instruments convertible into equity;*
 - (2) *not more than 30% of the investible funds may be invested by way of -*

 - *subscription to the initial public offer of a VCU whose shares are proposed to be listed subject to lock in period of one year;*
 - *preferential allotment of equity of a listed VCU subject to lock in period of one year;*
 - *debt / debt instrument to a venture capital undertaking in which VCF has already made investments by way of equity.*
- (iv) *The existing provisions under the SEBI regulations for investment in listed securities of financially weak or sick companies may be dispensed with as such investments would get covered under the 30% limit.*
- (v) *The existing provisions under SEBI regulations permitting financial assistance in any other manner, to companies in whose equity shares venture capital fund has invested, needs to be dispensed with as this also gets covered in 30% limit.*
- (d) *The registered FVCI should be permitted to invest and exit in a hassle free automatic route as permitted to FIIs without requirement of approval of pricing by RBI.*
- (e) *The provisions under Section 370 & 372 under the Companies Act relating to Inter-corporate Investment and Inter-corporate Loan should be relaxed in the case of venture capital funds incorporated as Companies.*
- (f) *In order to facilitate investment by VCF in new enterprises, the Companies Act may be amended so as to permit issue of shares by unlisted public companies with a differential right in regard to voting and dividend. Such a flexibility already exists under the Indian Companies Act in the case of private companies which are not subsidiaries of public limited companies.*



7.3 Flexibility in Exit

7.3.1 *Venture capital funds are set up to make investment in venture capital undertakings for a defined timeframe say 8-12 years. As and when investment matures, the investors are paid back the returns and on expiry of the timeframe, the funds are liquidated. The structure of VCF therefore should be such that its liquidation is simpler. In India, a VCF can be incorporated as a trust, a company or a body corporate. The liquidation of trust is comparatively easier as compared to that of a company or a body corporate. The guidelines for buyback of shares by the company are not adequate to facilitate the liquidation process and distribution of capital among the shareholders. Because of cumbersome liquidation procedure to be followed in the case of a company, most of the funds in India had been set up as a trust. Structures such as LP, LLP and LLC (which have been discussed in the Report earlier) are popular amongst international venture capitalists because of their easy liquidation procedure. This is one of the main reasons the Committee has recommended necessary amendments in the statutes to permit incorporation of LP, LLP and LLC in India.*

7.3.2 *In the case of a VCF constituted as a company, the existing guidelines for buyback of shares should be relaxed to permit them to buyback the shares out of the sale proceeds of investments and assets instead of reserves, share premiums and fresh issue proceeds. The buyback relaxation should also be extended to a VCU which proposes to buyback the equity from the VCF. This would provide an exit opportunity to the VCF. The existing conditions for buyback of equity shares by an unlisted company prohibit the company from making a fresh issue of capital for a period of 24 months. This has been a major constraining factor for growth oriented companies, to buyback their shares, even if they have a cash surplus. The prohibition period for fresh issue of capital may be reduced to a period of six months as VCUs are typically growing companies and they may need financing and should not be debarred from making fresh issue of capital for a longer period of time. The existing guidelines also do not permit the negotiated deal even in unlisted equity. The provision may be suitably relaxed in the case of transaction where VCF is one of the parties.*

7.3.3 *A VCF gets an opportunity to exit from the investment when VCU shares are listed on a recognised stock exchange. The present IPO guidelines of SEBI requires a three years track record of profit for a company to float a public issue. However, some of the companies operating in emerging areas such as internet and e-commerce may not be in a position to generate profits yet they have adequate market share in business to justify a significant market capitalisation. Also these type of companies are at present seeking listing outside country. This deprives domestic venture capital funds of an exit on listing of stock of VCU. The IPO norms and listing requirements need to be reviewed in the cases of companies funded by VCFs to facilitate early exit for them. The present benefit of*



project appraised and funded by Bank/Financial Institution should also be extended to project financed by the registered venture capital funds. The revised IPO criteria would be either companies having three years track record of profitability or the project is funded to the extent of 10% by Banks, Financial Institutions or registered venture capital fund. The participation of the venture capital fund to the extent of 10% of the project cost however should be locked in for a period of one year. Those companies which are funded by Venture capitalists and their securities are listed on the stock exchanges outside the country, these companies should be permitted to list their shares on the Indian stock exchanges.

7.3.4 The VCF enter into an agreement with the VCU at the time of commitment for participation in the venture which inter alia includes an option to the VCF to buy or sell the securities from / to the promoters. The legality of such an agreement is not clear in the light of Circular issued by Government of India 1969 under Section 16 of SC(R)A when the share of the VCU are listed on the stock exchange. Further, in the event of shares being listed on the stock exchange, the exercising of the right by VCF may trigger off SEBI Takeover Code. The necessary exemptions may be granted to VCF to enable them to exercise their contractual rights within the framework of law.

7.3.5 The trading in unlisted securities are not held in an organised manner in India. The transaction in unlisted securities are primarily bi-lateral contracts among the buyer and seller. SEBI has permitted OTCEI to develop a platform where it will facilitate trading in unlisted equities between qualified investors. This would help in arriving at the prices of unlisted securities as per the market forces. The VCF and FVCI registered with SEBI should be considered eligible for qualified investor and at the same time the joint promoters of the ventures should also be eligible to be qualified investors.

7.3.6 If FVCI disinvest and transfer its holding in VCU in favour of any other person, it is required by RBI to obtain a NOC from the joint venture partner and other shareholders. The process of obtaining NOC is time consuming and cause uncertainty about the transaction for a FVCI as joint venture partners may create obstacle in the exit route for VCFs. The requirement for obtaining NOC should be dispensed with.

7.3.7 RECOMMENDATIONS

In view of the above background, the following recommendations are proposed:

*(a) **Relaxing buyback requirements** : The provisions under the Companies Act for buyback of securities needs to be amended as under :*



- 24 months prohibition period for fresh issue of capital to be reduced to 6 months in the case of unlisted companies where the buyback of shares is from the VC investors ;
 - negotiated deals be permitted in unlisted companies where one of the party to the deal is venture capital investor;
 - permit VCC / VCU to redeem their equity shares / preference shares to an extent of 100% of their paid up capital out of sale proceeds of investment and assets and not necessarily out of free reserves, securities premium account or the proceed of fresh issue should apply to them.
- (b) **Relaxing Takeover Code** : The venture capital fund while exercising its call or put option as per the terms of agreement should be exempt from applicability of takeover code and 1969 circular under section 16 of SC(R)A issued by the Government of India.
- (c) **Relaxing the IPO norms** :The existing requirement under the SEBI (Initial Public Offer) Guidelines for three years track record of profit should be relaxed in the case of companies funded by VCFs. Further, the companies whose shares are already listed on stock exchanges outside India, the listing rules should be relaxed to permit the listing of shares of these companies on Indian Stock exchanges. Those companies which are funded by Venture capitalists and their securities are listed on the stock exchanges outside the country, these companies should be permitted to list their shares on the Indian stock exchanges.
- (d) **QIB market for unlisted securities** : The market for trading in unlisted securities should be promoted. The VCF / joint promoters should be eligible as qualified investor to participate in the unlisted equity segment of OTCEI or any other stock exchange permitted by SEBI.
- (e) **NOC requirement** : In the case of transfer of securities by FVCIs to any another person, the RBI requirement of obtaining NOC from joint venture partner or other shareholders should be dispensed with.
- (f) **RBI pricing norms** : The FVCI should be permitted to invest and exit from any investment as like FIIs without any requirement of prior approval of the pricing of securities by RBI.

8.0 GLOBAL INTEGRATION AND OPPORTUNITIES

8.1 *Incentive for Employees - Employees Stock Option Plan (ESOP)*

8.1.1 Currently, the Stock Options shall be available to non-resident and resident permanent employees (including Indian and overseas working directors) of the company. The Stock options shall not be available to the promoters and their relatives as(defined under the Companies Act). Venture Capital funded companies typically have a large option pool for their employees from 5-30% of the Issued equity. This would include Incubator, CEO and the Start-up team.



Currently, these persons would come under the meaning of “Promoter” under the ESOP guidelines and hence may not qualify for ESOP. This has to be amended to exempt Venture Capital funded companies.

- 8.1.2 *Currently, the RBI permit's Indian resident employees investment upto US\$10,000 in a period of 5 years under an employee Stock Option Scheme of a foreign company. This limit should be enhanced to US\$100,000 during a five year period.*
- 8.1.3 *The general FERA permission for resident employees of software companies under the ADR/GDR linked stock option scheme has been granted by the Reserve bank of India which entitles a resident employee to acquire and /or hold ADR/GDR linked stock option, acquire ADR/GDR on exercise of the option, remit funds upto a limit of \$50,000 in a block of five years for acquisition of ADRs/GDRs and to retain or continue holding ADRs/GDRs so acquired. The resident employee upon liquidation of the ADR/GDR holding would need to repatriate the proceeds to India unless a general/specific permission from the RBI is obtained for its retention or use abroad. This limit should be enhanced to US\$100,000 during a five year period.*
- 8.1.4 *Currently, if foreign employees wish to participate in Employees Stock Option Scheme of an Indian Company with repatriation benefits then, they can do so on an automatic basis within the overall ceiling of 50% or 51% or 74% of the shares of the Indian Company depending on the type of industry in which the Indian Company is engaged. It is proposed that foreign employees be allowed to participate under an Employee Stock Option Scheme so as to invest in shares of an Indian Company with full repatriation benefits with an upper ceiling of US\$100,000 over five years.*

8.2 Incidence of tax

- 8.2.1 *At present, when the option is exercised by the employee, it is taxed in the hands of employee as income from salary and when the shares are actually sold, that is taxed separately. It is recommended that the employees who have opted to exercise their option under ESOP be taxed only at the time of exit i.e. sale of shares by them and not at the time of exercise of the option. Globally this practice is followed in many countries..*

8.3 Incentives for Shareholders:

- 8.3.1 *The shareholders of an Indian company that has venture capital funding and is desirous of swapping its shares with that of a foreign company should be permitted to do so. Similarly, if an Indian company having venture funding and is desirous of issuing an ADR/GDR, venture capital shareholders (holding saleable stock) of the domestic company and desirous of disinvesting their shares*



through the ADR/GDR should be permitted to do so. Internationally, 70% of successful startups are acquired through a stock-swap transaction rather than being purchased for cash or going public through an IPO. Such flexibility should be available for Indian startups as well. Similarly, shareholders can take advantage of the higher valuations in overseas markets while divesting their holdings.

8.4 Global investment opportunities for domestic VCFs

8.4.1 *With increasing global integration, it is important that the domestic venture capital funds also have the opportunities to invest abroad. This would enable them to generate better returns globally and also expose them to the international market practices. We need to encourage Indian enterprises to become global. The domestic VCF should be permitted to make investments abroad under certain transparent, automatic norms subject to ceilings.*

8.4.2 *It is recommended that domestic VC Funds should be permitted to invest in securities of companies incorporated outside India. Such investment may be subject to a ceiling of higher of -*

- *25% of the Fund Corpus, or*
- *US\$ 10 million per VC Fund or*
- *to the extent of foreign investment in the corpus of the VC Fund*

8.5 Liberalise Sweat Equity issuance norms

8.5.1 *Under Section 79A of the Companies Act, 1956, a company can issue sweat equity only one year after it is entitled to commence business. This provision negates the possibility of sweat equity issuances in start-ups. The government should relax the one-year lock-in period.*

9.0 AMENDMENT IN SEBI REGULATIONS

9.1 *As in the case of FIIs, SEBI's primary role in the venture capital fund is envisaged as of a facilitator for growth rather than that of a regulator. SEBI Regulations should encourage more venture capital investments in a hassle free manner. The multiplicity of regulations, as far as possible, should be avoided and one set of regulatory guidelines may be issued under the aegis of one nodal agency for interface with the venture capital investors which could be SEBI. SEBI Regulations should focus more on adequate disclosure as investors in venture capital activities are institutions or high networth individuals who are expected to have the capability of taking an informed decision based on the disclosures. The regulatory requirement of seeking approval of the placement*



memorandum from SEBI may be dispensed with by strengthening the disclosure requirements. The SEBI Regulations also provide in the case of a VCF incorporated as a trust for compulsory registration of instrument of trust under the Indian Registration Act. As per the provisions of Indian Registration Act, the registration of trust document is optional. There are operational problems in the case of existing VCFs (in existence before SEBI Regulations were notified) to register the document of trust after lapse of four months period. It should be left to the choice of the applicant whether to register the trust document and there should not be any compulsion for registration of documents under the Indian Registration Act under the SEBI Regulation. The venture capital activity is in nascent stage in India as of today and many dimensions of it are still to be unfolded. SEBI Regulations therefore should not curtail the flexibility of investment by a VCF.

- 9.2 *The present regulatory framework permits the investment by VCF in sick industrial undertaking needs a review. There are various agencies who are engaged in restructuring, financing to sick industries and there is no acute necessity for venture capital funds to invest mainly in sick industrial undertakings. The VCF should focus on investment in green shoe high technology oriented, knowledge based, research oriented industries, however, VCFs may also be provided flexibility to participate in the restructuring process of sick industries as and when required.*

9.3 **Recommendations**

The following amendments are recommended under the existing SEBI Venture Capital Regulations :

- (a) *The definition of VCF should be amended to include any other structures and also the funds set up, scheme floated by a trust, company, body corporate or other legal entities.*
- (b) *The Regulation should make provisions for registration of Foreign Venture Capital Investors (FVCI).*
- (c) *The investment criteria needs to be redefined to permit investment by VCF primarily in equity or equity related instruments or securities convertible into equity of VCU and also by way of subscription to IPO and preferential offer in case of companies to be listed or already listed. The limit of atleast 80% of the funds raised by the VCF may be dispensed with and new investment criteria as dealt under the heading Investment related issues may be incorporated.*



- (d) *The relaxations for venture capital undertaking/funds under SEBI Takeover Code and SEBI (Initial Public Offer) guidelines as dealt under the heading of Exit related issues may also be incorporated.*
- (e) *The provision for investment in sick companies and financial assistance in any other manner may be dispensed with.*
- (f) *The existing provisions for approval of placement memorandum by SEBI may be dispensed with but the content of placement memorandum may be strengthened to include all the significant information necessary for an investor to arrive at a fair decision.*
- (g) *SEBI regulations should be amended to dispense with the requirement of registration of the instrument of trust under the Indian Registration Act.*

10.0 INFRASTRUCTURE AND R&D

10.1 *Venture capital industry in India is still in its early stages and to give it a proper fillip it is important to develop related infrastructure as has been successfully done internationally specially in US, Taiwan and Israel. Following areas need due attention.*

10.2 **Incubators:** *Incubators are mostly non profit entities that provide value added advisory, informational and certain support infrastructure which includes productive office environment, finance and complementary resources. Incubators are mostly promoted by Government or professional organisations seeking to develop small enterprises in a particular area. In US even city government have promoted several incubators to capture a portion of Silicon Valley high technology business. Some times venture capitals funds also have their own incubators and companies also set up in-house incubators. Incubators typically give a very initial stage support to young entrepreneurs who want to develop their idea to a viable commercial proposition which could be financed and supported by venture capitalist. Incubators have been started by Government and public institutions, to encourage young talent by providing initial facilities and finance has really helped countries like US, Israel, Taiwan etc. According to US SBA statistics about 25% of incubator firms are successful (defined as profitability within 5 years of establishment).*

10.2.1 *Increasingly there are transnational incubators in Silicon Valley, Israel and Taiwan which provide the head start advantage of accessing global experience and environment to young entrepreneurs of the respective countries. In India, Central and State Governments, public institutions should support and set up incubators. Government should also consider giving infrastructural support and other incentives including tax incentives for promotion of incubators.*



10.2.2 *There is also need to consider some successful models which have supported venture capital activity and enterprise building in a substantial manner two such models are discussed hereunder:*

10.3 U.S. Small Business Investment Company (SBIC) Program

10.3.1 *The SBIC Program, administered by the U.S. Small Business Administration (SBA) is the largest government support program for venture capital in the world, and is a model to be considered, perhaps with modification, by other nations that want to stimulate venture capital investment. In 40 years of operation, SBICs have invested over \$21 billion in nearly 120,000 financings to U.S. small businesses, including such successes as Intel Corporation, Apple Computer, Federal Express and America Online.*

10.3.2 *The SBIC does not distinguish between types of businesses, although investments in buyouts, real estate, and oil exploration are prohibited. In 1998, the SBIC invested \$3.4 billion in 3,470 ventures, approximately 40 percent by number and 20 percent by dollar value of all venture capital financings. Over half that amount was given over to businesses three years old or younger. Companies such as Apple, America Online, Intel and Sun stand as some of the SBIC's more famous past financings, but the lesson of its success lies in successfully financing thousand of small, unknown firms.*

10.3.4 *The basic objective of the program is to attract and supplement private capital for venture capital funds (SBICs), managed by private investment managers, that invest in small companies that would not otherwise be able to raise capital from purely private sources. Many require amounts of capital greater than that available from individuals, but less than the minimum required by private venture capital firms. In this program, SBA licenses, regulates, and agrees to provide two thirds of the total capital of an SBIC with the remaining one third provided as equity by private investors such as insurance companies, foundations, endowments, wealthy individuals and pension plans. The SBICs are organised and are operated just like private venture capital funds, with all investment decisions made by the private fund manager.*

10.3.5 *SBICs agree to abide by SBA regulations, primarily to make only direct investments in companies small enough to meet required standards. Except for the exclusion of a few industries, investments are not targeted by SBA. Capital supplied by SBA requires a rate of return much lower than that expected by the fund as a whole. Any excess flows to the private investors and fund managers, increasing or “leveraging” their returns.*



10.3.6 *SBA funds are provided either through 10 year loans (“debentures”) or preferred limited partnership equity investments (“participating securities”). Debentures require current payment of interest and are used by SBICs that make loans with equity rights or features. Participating securities, which have no current cash payment obligation, are used by SBICs that make equity investments in small companies. The rate and fees of the debentures to the SBIC are about 2% above the ten-year U.S. treasury rate. In addition to this basic cost, SBICs using participating securities must pay 10% of their profits to SBA.*

10.3.7 *Funds for the program are raised by SBA in the capital markets through the sale of debentures guaranteed by SBA and the U.S. government. In the U.S. budget system, the only required government appropriation is a “credit subsidy” or form of loss reserve, which now is less than 2% of the value of the financings. This year, an appropriation of \$27 million will allow SBA to guarantee \$2.3 billion of debt, proceeds of which will be made available to SBICs with private capital of around \$1.2 billion, thus making \$3.5 billion available for investment in U.S. small businesses.*

10.3.8 *In addition to making 45% of the total number of equity financings made by venture capital firms to U.S. small business last year, with an average investment size well below that of private venture firms, the SBIC program assists new fund managers who are raising their first funds. The program is achieving its objectives and helping to build the venture capital industry of the future.*

10.3.9 *The SBIC program undoubtedly has relevance for India, and it is possible a structure could be implemented in which Indian venture capital firms registered with SEBI could avail themselves of those funds.*

10.4 The Bilateral Industrial Research and Development Foundation (BIRD), Israel

10.4.1 *Israel’s government participates in international cooperation, seeking to match the nation’s technical skills with global markets and to share start-up risks up front with later-stage activities such as marketing. The most successful of these ventures has been the Bilateral Industrial Research and Development Foundation (BIRD). Begun in 1977 as an equal partnership with the U.S. government, the BIRD Foundation was seeded with \$110 million to fund joint ventures between Israeli and U.S. firms. BIRD provides 50 percent of a company’s R&D expenses, with equal amounts going to each partner. Its return comes from the royalties it charges on the company’s revenue.*

10.4.2 *Any pair of companies, one from each country, may jointly apply for BIRD support, if between them they have the capability and infrastructure to define, develop, manufacture, sell and support an innovative product based on industrial R&D.*



10.4.3 *BIRD often plays a proactive role in bringing potential strategic partners together. In the US, the companies are mostly public or at least bound in that direction and are engaged in the development and manufacture of high technology products. The potential of these companies to grow is perceived as limited only by their capacity to devise and develop new products. In Israel, the companies BIRD recruit have leading-edge technological and production capabilities, are flexible and are eager to join forces with an American company in product development and commercialization.*

10.4.4 *In practice, only 25 percent of the funded projects have been successful, but this is a satisfactory rate even for private funds. The monies BIRD has earned on profitable projects more than offset losses made by the rest, thus allowing the Foundation to maintain the value of its corpus, BIRD approves about forty new projects a year, with average funding of \$1.2 million for a duration of twelve to fifteen months. It has so far funded five hundred such projects.*

11.0 AWARENESS CREATION

11.1 *Proper awareness of venture capital activity is important for its development. There should be public accessibility to relevant information and data regarding venture capital activity. One immediate measure could be creation of an informed website which could have sufficient and useful data on venture capital activity.*

12.0 SELF REGULATORY ORGANISATION(SRO)

12.1 *It is also desirable that a **Self Regulatory Organisation** for venture capital industry in India is created. Such organisation would help in evolution of standard practices, code of conduct, apart from generating and disseminating information about the industry.*

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



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