

## **SECURITIES LAWS AND COMPLIANCES**

### **PART A — SECURITIES LAWS**

#### **STUDY X - VENTURE CAPITAL**

##### **LEARNING OBJECTIVES**

The study will enable the students to understand

- Concept of Venture Capital
- Venture Capital-Domestic and International Scenario
- Overview of SEBI(Venture Capital Funds) Regulations, 1996
- SEBI(Foreign Venture Capital Investors) Regulations, 2000

##### **INTRODUCTION**

Venture capital is the capital that is invested in equity or debt securities (with equity conversion terms) of young unseasoned companies promoted by technocrats who attempt to break new path. It is a source of finance for new or relatively new, high risk, high profit potential products as the projects belong to untried segments or technologies. It is difficult for the promoters to obtain finance from conventional sources. The venture capitalists step-in to fill this gap. The venture capitalists are knowledgeable and sophisticated investors who come forward to face higher risks with the calculated hope of making much higher gains when the new projects succeed. They work on the theory that the greater the risk, the greater will be the profit. The success of a venture capital project depends on the care with which the projects are evaluated and selected for investment and the trust in the capabilities of the promoters in making a success of their projects. Venture capitalists take faster decisions in appraising projects and releasing funds than Banks and FIs.

A Venture Capital Fund (VCF) thus strives to provide entrepreneurs with the support they need to create up-scalable business with sustainable growth, while providing their contributors with outstanding returns on investment, for the higher risks they assume.

Venture Capital Fund generally provides following services:

- Finance new and rapidly growing companies
- Typically knowledge-based, sustainable, up scaleable companies
- Purchase equity/quasi-equity securities
- Assist in the development of new products or services
- Add value to the company through active participation
- Take higher risks with the expectation of higher rewards
- Have a long-term orientation.

##### **I. Venture Capital - Domestic and International Scenario**

The growth of venture capital in India was stimulated in the late 1980s with a series of measures to establish government sponsored risk capital corporations and capital gains tax concessions for venture capital investments (Verma, 1997). The venture capital industry in India has subsequently witnessed increased activity with a rise in the number as well

as the pool of funds for investment (IVCA Venture Activity, 1997). By 1998 total investment funds under management amounted to approximately \$1.1 billions (AVCJ, 1999). In 1998 foreign institutional investors contributed 51 per cent of the total pool of funds as compared to 26 per cent contributed by the all India financial institutions. The balance of funds is provided by a mixture of multinational agencies, commercial banks (nationalised and others), insurance companies, corporate sector mutual funds, non-resident Indians, other public sector providers, etc. The venture capital industry is dominated by early stage investments (59.2% of value and 66.2% of numbers of investments, IVCA, 1999) while the largest industrial sector in the Indian market is industrial products (23.5% of investment value). Computer software is second largest, followed by computer hardware accounting for a further 5.9% and biotechnology and tele and data communications 5.4% of the value of investments in 1998.

The first origin of modern day Venture Capital in India can be traced to the setting up of a Technology Development Fund (TDF) in the year 1987-88, through the levy of a cess on all technology import payments.

In 1996, SEBI came out with guidelines for venture capital funds, which paved the way for entry of foreign venture funds into India. Today, the total pool of Indian Venture Capital today, stands over Rs. 50 bn.

### **Current Trends**

- Capital is pouring into private equity funds
- Average ticket size of VC investment is increasing
- First generation entrepreneurs are finding easier to raise funds
- Investors are demanding non financial value additions
- Most States are setting regional VC funds
- VC firms are getting professionalised
- Incubators and serial entrepreneurs are germinating
- VC firms are getting specific industry focused
- Competition is stretching valuations.

### **International Scenario**

In the fifteenth century, Christopher Columbus sought to travel westwards instead of eastwards from Europe, to reach India. His far-fetched idea did not find favor with the King of Portugal, who refused to finance him. Finally, Queen Isabella of Spain, decided to “fund” him for his venture. And thus evolved the concept of Venture Capital.

The modern venture capital industry began taking shape in the post-World War II. In 1946, American Research and Development Corporation, was founded which graduated to become a pioneer venture capitalist. It's VC investment in Digital Equipment provided it with an astounding 101% annualized Return on Investment.

In mid 1950s, US government recognized the need for risk capital and promoted Small Business Investment Companies (SBIC).

In the late 1960s VC industry followed the seven-year slump of the US stock markets. It looked up only in late 1970s, on massive reduction in capital gains tax rate and a number of high-profile IPOs by venture-backed companies, like Federal Express and Apple Computer.

1980s marked the explosion in the venture capital business marked by the transition of the primary source of venture capital funds from wealthy individuals and families to endowment, pension and other institutional funds. Predictably returns on venture capital investments plunged. Since 1990s, the venture capital industry in US is having tremendous growth. The current area of focus being knowledge based companies.

### **India, Internet captured largest shares of VC**

India secured the largest amount of venture capital funding in the region in 2001, pulling \$841.5 million equivalent to a 24% share of funding in Asia Pacific.

The Internet sector continued to attract the lion's share of venture capital in Asia, securing \$916.8 million. This sector attracted the same number of rounds as it did in 2000, but the dollar total was less than one-third of the \$2.2 billion amount in 2000, reflecting the global drop in Internet company valuations. Communications and media also continued to remain popular with venture capitalists, attracting \$833.7 million.

Expansion-stage companies captured the largest portion of investments, as 195 companies received \$1.7 billion. Twenty-five buyout and acquisition stage companies receiving \$794 million and 61 early-stage companies securing \$455.9 million to round out the top three stages. Investments in special situation/other companies totalled \$443.4 million, with 26 companies receiving financing; 49 seeds/startup companies secured \$85.3 million; and nine later stage companies received \$28.8 million.

Since 1990s, the venture capital industry in US is having tremendous growth. The current area of focus being knowledge based companies.

### **Speciality about industry**

Venture Capital is money provided by professionals who invest alongside management in rapidly growing companies; Venture Capital derives its value from the brand equity, professional image, constructive criticism, domain knowledge, industry contacts; they bring to table at a significantly lower management agency cost.

Venture capital financing may be interpreted as an agency relation between the VC (the principal) and the E (the agent), the latter selling to the former a stake of his starting-up enterprise. This transaction is governed by long-term contractual provisions.

VCs typically concentrated in industries with a great deal of uncertainty, where the information gap among Es and investors is commonplace.

Therefore, information asymmetries and moral hazard provoke agency costs, related to the E's opportunistic behavior. First, Es might invest in projects that have high personal returns and private benefits but low expected monetary payoffs. Similarly, they have the incentive to pursue high-variance strategies since they claim a call option on the equity capital.

Venture capitalists typically raise funds largely from investors such as financial institutions, banks, pension funds, corporations, endowments/foundations and high net-worth individuals. Pension funds contribute nearly 55% of the resources of the venture capitalists in the US but only 5% in Japan. In Europe, an estimated 24% of resources raised by

venture capitalists during 2000 were from pension funds, followed by banks (22%) and, insurance companies (13%). While the US has allowed pension funds to invest in private equity since 1979, many countries (including India) prohibit pension funds from participating in the VC market. Unlike in Europe, banks in the US account for a much smaller percentage of VC financing because US banking laws impose more restrictions on banks making equity investments in companies in their loan portfolios. In India, banks have traditionally been the dominant providers of institutional financing to firms and economic entities:

1. An Indian scheduled commercial banks (SCBs) aggregate investment in shares, convertible debentures, bonds, etc. should not exceed 5% of their total outstanding advances (including Commercial Paper) as on March 31 of the previous year. The ceiling excludes a SCBs investment in venture capital, including units of dedicated VC funds meant for Information Technology (IT), subject to the condition that the VC funds/companies are registered with the Securities and Exchange Board of India (SEBI). However, banks investments are negligible primarily because of their traditional risk-averse behavior. As compared with risky equity investments, most SCBs in India prefer the safety of Government securities.
2. Most startups incur losses in the early stages of their existence. The existing guidelines for valuation of equity shares held by SCBs specify that equity shares for which current quotations are not available or which are not quoted on the stock exchanges should be valued at break-up value (without considering revaluation reserves).

### **Categorization**

The “venture funds” available could be form:

#### *Incubators*

An incubator is a hardcore technocrat who works with an entrepreneur to develop a business idea, and prepares a Company for subsequent rounds of growth & funding. E Ventures, Infinity are examples of incubators in India.

#### *Angel Investors*

An angel is an experienced industry-bred individual with high net worth. Typically, an angel investor would invest only his chosen field of technology, take active participation in day-to-day running of the Company invest small sums in the range of USD 1-3 million not insist on detailed business plans sanction the investment in up to a month help company for “second round” of funding.

#### *Venture Capitalists (VCs)*

VCs are organizations raising funds from numerous investors and hiring experienced professional managers to deploy the same. They typically: invest at “second” stage invest over a spectrum over industry/ies have hand-holding “mentor” approach insist on detailed business plans invest into proven ideas/businesses provide “brand” value to investee invest between USD 2-5 million.

#### *Private Equity Players*

They are established investment bankers. They typically invest into proven/ established businesses. They have “financial partners” approach and invest between USD 5-100 million.

#### *Trust or a Company*

A fund established in the form of a trust or a company including a body corporate and registered under SEBI Regulations and which has a dedicated pool of capital, raised in a manner specified in the Regulations and invests in venture Capital undertaking.

## **II. SEBI (Venture Capital Funds) Regulations, 1996**

These Regulations were notified by SEBI in exercise of the powers conferred by section 30 of SEBI Act, 1992 and took effect from 4th December, 1996.

‘Venture capital fund’ under the Regulations means a fund established in the form of a trust or a company including a body corporate and registered under these regulations which—

- i. has a dedicated pool of capital,
- ii. raised in a manner specified in the regulations, and
- iii. invests in venture capital undertaking in accordance with the regulations.

Trust for the purpose means a trust established under the Indian Trusts Act, 1882 or under an Act of Parliament or State Legislation.

Unit means beneficial interest of the investors in the scheme or fund floated by trust or shares issued by a company including a body corporate.

Venture capital undertaking means a domestic company –

- i. whose shares are not listed on a recognised stock exchange in India;
- ii. which is engaged in the business for providing services, production or manufacture of article or things or does not include such activities or sectors which are specified in the negative list by SEBI with the approval of the Central Government by notification in the Official Gazette in this behalf.

### **Registration of Venture Capital Funds**

Any company or trust or a body corporate in order to carry on any activity as a venture capital fund on or after the commencement of the regulations have to make an application to SEBI for grant of a certificate. An application for grant of certificate should be made to SEBI in the prescribed form accompanied by a non-refundable application fee as specified. Any company or a body corporate who fails to make an application for grant of a certificate within the period specified should cease to carry on any of its activity as a venture capital fund.

### **Eligibility Criteria**

The applicant for registration as Venture Capital Fund should fulfil the following conditions:

1. if the application is made by a company, -
  - a. memorandum of association has as its main objective, the carrying on of the activity of a venture capital fund;
  - b. it is prohibited by its memorandum and articles of association from making an invitation to the public to subscribe to its securities;

- c. its director or principal officer or employee is not involved in any litigation connected with the securities market which may have an adverse bearing on the business of the applicant;
  - d. its director, principal officer or employee has not at any time been convicted of any offence involving moral turpitude or any economic offence.
  - e. it is a fit and proper person.
2. if the application is made by a trust, -
- a. the instrument of trust is in the form of a deed and has been duly registered under the provisions of the Indian Registration Act, 1908 (16 of 1908);
  - b. the main object of the trust is to carry on the activity of a venture capital fund;
  - c. the directors of its trustee company, if any, or any trustee is not involved in any litigation connected with the securities market which may have an adverse bearing on the business of the applicant;
  - d. the directors of its trustee company, if any, or a trustee has not at any time, been convicted of any offence involving moral turpitude or of any economic offence;
  - e. the applicant is a fit and proper person.
3. if the application is made by a body corporate
- a. it is set up or established under the laws of the Central or State Legislature.
  - b. the applicant is permitted to carry on the activities of a venture capital fund.
  - c. the applicant is a fit and proper person.
  - d. the directors or the trustees, as the case may be, of such body corporate have not been convicted of any offence involving moral turpitude or of any economic offense.
  - e. the directors or the trustees, as the case may be, of such body corporate, if any, is not involved in any litigation connected with the securities market which may have an adverse bearing on the business of the applicant.
4. the applicant has not been refused a certificate by SEBI or its certificate has not been suspended or cancelled under the Regulations 30.

SEBI may require the applicant to furnish further information, if it considers necessary.

### **Consideration of application**

An application, which is not complete in all respects should be rejected by SEBI. However before rejecting any such application, the applicant should be given an opportunity to remove, within thirty days of the date of receipt of communication, the objections indicated by SEBI. On being satisfied that it is necessary to extend the period, SEBI can extend such period by such further time not exceeding ninety days.

### **Procedure for grant of certificate**

SEBI after getting satisfied that the applicant is eligible for the grant of certificate should send intimation to the applicant and after the receipt of

intimation, the applicant should pay the registration fee as specified. SEBI on receipt of the registration fee grants a certificate of registration. The venture capital fund should abide by the provisions of the Act. It should not carry on any other activity other than that of a venture capital fund and should forthwith inform SEBI in writing. If any information or particulars previously submitted to SEBI are found to be false or misleading in any material particular or if there is any change in the information already submitted. After considering an application, if SEBI is of the opinion that a certificate should not be granted, it can reject the application after giving the applicant a reasonable opportunity of being heard. The decision of SEBI to reject the application should be communicated to the applicant within thirty days.

#### **Effect of refusal to grant certificate**

Any applicant whose application has been rejected cannot carry on any activity as a venture capital fund. Thus any company or trust or a body corporate whose application for grant of certificate has been rejected by SEBI should on and from the date of the receipt of the communication ceases to carry on any activity as a venture capital fund. SEBI in the interest of the investors has the right to issue directions with regard to the transfer of records, documents or securities or disposal of investments relating to its activities as a venture capital fund and can also appoint any person to take charge of records, documents, securities and for this purpose also determine the terms and conditions of such an appointment.

#### **Investment Conditions and Restrictions**

A venture capital fund can raise monies from any investor whether Indian, foreign or non-resident Indians by way of issue of units. No venture capital fund set up as a company or any scheme of a venture capital fund or set up as a trust can accept any investment from any investor which is less than five lakh rupees. However nothing applies to investors who are the employees or the principal officer or directors of the venture capital fund, or directors of the trustee company or trustees where the venture capital fund has been established as a trust; or the employees of the fund manager or asset management company. Each scheme launched or fund set up by a venture capital fund should have firm commitment from the investors for contribution of an amount of at least Rupees five crores before the start of operations by the venture capital fund.

Venture capital fund is required to disclose the investment strategy at the time of application for registration and should not invest more than 25% corpus of the fund in one venture capital undertaking. Venture capital fund may invest in Securities of foreign companies subject to such conditions or guidelines that may be stipulated or issued by RBI and SEBI from time to time. It should also not invest in the associated companies. Venture capital fund shall make the investment in the venture capital undertaking as given below:

- i. at least 66.67% of the investible funds shall be invested in unlisted equity shares or equity linked instruments of venture capital undertaking.

- ii. not more than 33.33% of the investible funds can be invested by way of subscription to initial public offer of a venture capital undertaking whose shares are proposed to be listed; debt or debt instrument of a venture capital undertaking in which the venture capital fund has already made an investment by way of equity, preferential allotment of equity shares of a listed company subject to lock-in period of one year, equity shares or equity linked instrument of financing weak company or a sick individual company whose shares are listed and special purpose vehicles created by VCF for the purpose of facilitating or promoting investment in accordance with these regulations.

### **Prohibition on listing**

No venture capital fund is entitled to get its units listed on any recognised stock exchange till the expiry of three years from the date of the issuance of units by the venture capital fund.

### **Restrictions on investment by a venture capital fund**

All investments made or to be made by a venture capital fund are subject to the following restrictions:

The venture capital fund should not invest in the equity shares of any company or institution providing financial services and at least 80 percent of funds raised by a venture capital fund should be invested in:

- i. the equity shares or equity related securities issued by a company whose securities are not listed on any recognised stock exchange.  
However it has been provided that a venture capital fund may invest in equity shares or equity related securities of a company whose securities are to be listed or are listed where the venture capital fund has made these investments through private placements prior to the listing of the securities.
- ii. the equity shares or equity related securities of a financially weak company or a sick industrial company, whose securities may or may not be listed on any recognised stock-exchange.  
"Financially weak company" for the purpose means a company, which has at the end of the previous financial year accumulated losses, which has resulted in erosion of more than 50% but less than 100% of its networth as at the beginning of the previous financial year.
- iii. providing financial assistance in any other manner to companies in whose equity shares the venture capital fund has invested under sub-clause (i) or sub-clause (ii), as the case may be.

The expression "funds raised" means the actual monies raised from investors for subscribing to the securities of the venture capital fund and includes monies raised from the author of the trust in case the venture capital fund has been established as a trust but shall not include the paid up capital of the trustee company, if any.

### **General Obligations and Responsibilities**

No venture capital fund can issue any document or advertisement inviting offers from the public for the subscription or purchase of any of its units. A venture capital fund can receive monies for investment in the venture capital fund only through private placement of its units.



**Maintenance of books and records**

Every venture capital fund is required to maintain for a period of eight years books of accounts, records and documents which shall give a true and fair picture of the state of affairs of the venture capital fund. Every venture capital fund should intimate SEBI, in writing, the place where the books, records and documents.

**Powers of SEBI**

SEBI can at any time call for any information from a venture capital fund with respect to any matter relating to its activity as a venture capital fund. Where any information is called for, it should be furnished within the time specified by SEBI. SEBI may at any time call upon the venture capital fund to file such reports as SEBI may desire with regard to the activities carried on by the venture capital fund.

**Winding up**

A scheme of a venture capital fund set up as a trust should be wound up if—

- a. the period of the scheme, if any, mentioned in the placement memorandum is over;
- b. in the opinion of the trustees or the trustee company, that the scheme should be wound up in the interests of investors in the units;
- c. if seventy five percent of the investors in the scheme pass a resolution at a meeting of unit holders that the scheme be wound up or if SEBI so directs in the interests of investors.

A venture capital fund set up as a company should be wound up in accordance with the provisions of the Companies Act, 1956. It should be wound up in accordance with the provisions of the statute under which it is constituted. The trustees or trustee company of the venture capital fund set up as a trust or SEBI of Directors in the case of the venture capital fund is set up as a company (including body corporate) should intimate SEBI and investors of the circumstances leading to the winding up of the Fund or Scheme.

No further investments should be made on behalf of the scheme so wound up on and from the date of intimation. Within three months from the date of intimation, the assets of the scheme should be liquidated, and the proceeds accruing to investors in the scheme be distributed to them after satisfying all liabilities.

**Placement Memorandum**

The venture capital fund established as a trust before issuing any units file a placement memorandum with SEBI which should give details of the terms subject to which monies are proposed to be raised from investors. A venture capital fund established as a company should before making an offer inviting any subscription to its securities, file with SEBI a placement memorandum which shall give details of the terms subject to which monies are proposed to be raised from the investors.

The placement memorandum should contain the following, namely:

- i. details of the securities that are being offered;
- ii. details of investments that are proposed to be made;

- iii. details of directors of the company;
- iv. tax implications that are likely to apply to investors;
- v. manner of subscription to the securities that are to be issued;
- vi. manner in which the benefits accruing to investors in the securities are to be distributed; and
- vii. details of the asset management company, if any, and of fees to be paid to such a company.

The placement memorandum is to be issued for private circulation only after the expiry of twenty-one days of its submission to SEBI. However it has been provided that if within twenty one days of submission of the placement memorandum, SEBI communicates any amendments to the placement memorandum, the venture capital fund should carry out such amendments in the placement memorandum before such memorandum is circulated to the investors.

Amendments or changes to any placement memorandum already filed with SEBI can be made only if a copy of the placement memorandum indicating the changes is filed with SEBI and secondly within twenty one days of such filing, SEBI has not communicated any objections or observations on the said amendments or changes.

### **Inspection and Investigation**

SEBI can appoint one or more persons as inspecting or investigating officer to undertake inspection or investigation of the books of accounts, records and documents relating to a venture capital fund for any of the following reasons:

- a. to ensure that the books of account, records and documents are being maintained by the venture capital fund in the manner specified in these regulations;
- b. to inspect or investigate into complaints received from investors, clients or any other person, on any matter having a bearing on the activities of the venture capital fund;
- c. to ascertain whether the provisions of the Act and regulations are being complied with by the venture capital fund; and
- d. to inspect or investigate suo moto into the affairs of a venture capital fund, in the interest of the securities market or in the interest of investors.

### **Notice before inspection or investigation**

Before ordering an inspection or investigation SEBI should give notice to the venture capital fund. Where SEBI is satisfied that in the interest of the investors no such notice should be given, it can through order in writing direct that the inspection or investigation of the affairs of the venture capital fund be taken up without such notice. During the course of an inspection or investigation, the venture capital fund against whom the inspection or investigation is being carried out should be bound to discharge its obligations as provided in regulation.

### **Obligation of venture capital fund on inspection or investigation**

It is the duty of every officer of the Venture Capital Fund in respect of whom an inspection or investigation has been ordered and any other

associate person who is in possession of relevant information pertaining to conduct and affairs of such Venture Capital Fund including fund manager or asset management company, if any, to produce to the Investigating or Inspecting Officer such books, accounts and other documents in his custody or control and furnish him with such statements and information as the said Officer may require for the purposes of the investigation or inspection. Every officer of the Venture Capital Fund and any other associate person who is in possession of relevant information pertaining to conduct and affairs of the Venture Capital Fund required to give to the Inspecting or Investigating Officer all such assistance and should extend all such co-operation as required in connection with the inspection or investigations and should also furnish such information sought by the inspecting or investigating officer in connection with the inspection or investigation.

The Investigating or Inspecting Officer for the purposes of inspection or investigation, has the power to examine and record the statement of any employees, directors or person responsible for or connected with the activities of venture capital fund or any other associate person having relevant information pertaining to such Venture Capital Fund. The Inspecting or Investigating Officer should for the purposes of inspection or investigation, have power to obtain authenticated copies of documents, books, accounts of Venture Capital Fund, from any person having control or custody of such documents, books or accounts.

### **Submission of Report**

The inspecting or investigating officer as soon as possible on completion of the inspection or investigation submits an inspection or investigation report to SEBI. However if directed by SEBI, he may submit an interim report.

### **Communication of findings**

SEBI after consideration of the investigation or inspection report and after giving reasonable opportunity of hearing to the venture capital fund or its trustees, directors issue such direction as it deems fit in the interest of securities market or the investors including directors in the nature of:

- a. requiring a venture capital fund not to launch new schemes or raise money from investors for a particular period;
- b. prohibiting the person concerned from disposing of any of the properties of the fund or scheme acquired in violation of these regulations;
- c. requiring the person connected to dispose of the assets of the fund or scheme in a manner as specified in the directions;
- d. requiring the person concerned to refund any money or the assets to the concerned investors along with the requisite interest or otherwise, collected under the scheme;
- e. prohibiting the person concerned from operating in the capital market or from accessing the capital market for a specified period.

### **Inspection or Investigation**

It should be the duty of the venture capital fund whose affairs are being inspected or investigated, and of every director, officer and employee thereof, of its asset management company to produce before the

inspecting or investigating officer such books, securities, accounts, records and other documents in its custody or control and furnish him with such statements and information relating to the venture capital fund, as required by the investigation officer, within such reasonable period as the inspecting officer may specify. The venture capital fund should allow the inspecting or investigating officer to have reasonable access to the premises occupied by such venture capital fund or by any other person on his behalf and also extend reasonable facility for examining any books, records, documents and computer data in the possession of the venture capital fund or such other person and also provide copies of documents or other materials which, in the opinion of the inspecting or investigating officer are relevant for the purposes of the inspection or investigation, as the case may be. The inspecting or investigating officer, in the course of inspection or investigation is entitled to examine or to record the statements of any director, officer or employee of the venture capital fund. It is the duty of every director, officer or employee, trustee or director of the trustee company of the venture capital fund to give to the inspecting or investigating officer all assistance in connection with the inspection or investigation, which the inspecting or investigating officer may reasonably require.

SEBI after considering inspection or investigation report or the interim report communicate the findings of the inspection officer to the venture capital fund and give him an opportunity of being heard and on receipt of the reply if any, from the venture capital fund, SEBI can call them to take such measures as SEBI may deem fit in the interest of the securities market and for due compliance with the provisions of the Act and these regulations.

#### **Procedure for action in case of default**

A venture capital fund which –

- a. contravenes any of the provisions of the Act or these regulations;
- b. fails to furnish an information relating to its activity as venture capital fund as required by SEBI;
- c. furnishes to SEBI information which is false or misleading in any material particular;
- d. does not submit periodic returns or reports as required by SEBI;
- e. does not co-operate in any enquiry, inspection or investigation conducted by SEBI;
- f. fails to resolve the complaints of investors or fails to give a satisfactory reply to SEBI in this behalf,

should be dealt with in the manner provided in the Securities and Exchange Board of India.

#### **Suspension/Cancellation of certificate**

SEBI may suspend the certificate granted to a venture capital fund where the venture capital fund contravenes any of the provisions of the Act or these regulations; fails to furnish any information relating to its activity as a venture capital fund as required by SEBI; furnishes to SEBI information which is false or misleading in any material particular; does not submit

periodic returns or reports as required by SEBI; does not co-operate in any enquiry, inspection or investigation conducted by SEBI; or fails to resolve the complaints of investors or fails to give a satisfactory reply to SEBI in this behalf.

SEBI may cancel the certificate granted to a venture capital fund when the venture capital fund is guilty of fraud or has been convicted of an offence involving moral turpitude and secondly when the venture capital fund has been guilty of repeated defaults of the nature specified in regulation or contravenes any of the provisions of the Act or the regulations.

#### **Manner of holding enquiry before suspension or cancellation**

SEBI may appoint one or more enquiry officers. The enquiry officer have to issue a notice to the venture capital fund, at its registered office or its principal place of business setting out the grounds on which action is proposed to be taken against it and calling upon it to show cause against such action within a period of fourteen days from the date of receipt of the notice. Within fourteen days from the date of receipt of such notice, the venture capital fund have to furnish to the enquiry officer a written reply, together with copies of documentary or other evidence relied on by it or sought by SEBI from the venture capital fund.

The enquiry officer should give a reasonable opportunity of hearing to the venture capital fund to enable him to make submissions in support of its reply. The venture capital fund can appear before the enquiry officer, through any person duly authorised by the venture capital fund. However it has been provided that no lawyer or advocate should be permitted to represent the venture capital fund at the enquiry. It has been further provided that where a lawyer or an advocate has been appointed by SEBI as a presenting officer it will be lawful for the venture capital fund to present its case through a lawyer or advocate. The enquiry officer can ask SEBI to appoint a presenting officer to present its case, if necessary. After taking into account all relevant facts and submissions made by the venture capital fund, the enquiry officer is required to submit a report to SEBI and recommend the penal action, if any, to be taken against the venture capital fund as also the grounds on which the proposed action is justified.

#### **Show-cause notice and order**

After the receipt of the report from the enquiry officer, SEBI can consider the same and may issue to the venture capital fund a show-cause notice as to why the penal action as proposed by the enquiry officer or such appropriate action should not be taken against it. The venture capital fund is required to send a reply to SEBI within fourteen days of the date of the receipt of the show-cause notice. SEBI, after considering the reply, if any, of the venture capital fund will pass such order as it deems fit.

#### **Effect of suspension and cancellation of certificate**

The venture capital fund is required to cease its activity on and from the date of the suspension of the certificate, as a venture capital fund during the period of suspension, subject to the directions of SEBI with regard to any records, documents or securities that may be in its custody or control, relating to its activities as venture capital fund, as specified by SEBI.

The venture capital fund ceases to carry on any activity with immediate effect on and from the date of cancellation of the certificate as a venture capital fund, subject to such directions of SEBI with regard to the transfer of records, documents or securities that may be in its custody or control, relating to its activities as venture capital fund, as specified by SEBI. The order of suspension or cancellation of certificate passed is required to be published by SEBI in two newspapers.

### **III. SEBI (FOREIGN VENTURE CAPITAL INVESTORS) REGULATIONS, 2000**

Foreign Venture Capital Investor means an investor incorporated and established outside India, which proposes to make investment in venture capital fund(s) or venture capital undertakings in India and is registered under the Regulations.

As stated earlier, Venture Capital Fund means a Fund established in the form of a Trust, a company including a body corporate and registered under Securities and Exchange Board of India (Venture Capital Fund) Regulations, 1996, which has a dedicated pool of capital; raised in the manner specified under the Regulations; and invests in venture capital undertaking in accordance with the Regulations.

Venture capital undertaking means a domestic company whose shares are not listed in a recognised stock exchange in India; which is engaged in the business of providing services, production or manufacture of articles or things, but does not include such activities or sectors which are specified in the negative list by SEBI, with approval of Central Government, by notification in the Official Gazette in this behalf.

#### **Application for grant of certificate**

The applicant is required to make an application along with the registration fee to SEBI for the purposes of seeking registration in the form specified.

#### **Eligibility Criteria**

SEBI assesses the application of VCF on the following criteria:

- i. the applicants track record, professional competence, financial soundness, experience, general reputation of fairness and integrity;
- ii. whether the applicant has been granted necessary approval by the Reserve Bank of India for making investments in India;
- iii. whether the applicant is an investment company, investment trust, investment partnership, pension fund, mutual fund, endowment fund, university fund, charitable institution or any other entity incorporated outside India; or
- iv. whether the applicant is an asset management company, investment manager or investment management company or any other investment vehicle incorporated outside India;
- v. whether the applicant is authorised to invest in venture capital fund or carry on activity as a foreign venture capital investors;
- vi. whether the applicant is regulated by an appropriate foreign regulatory authority or is an income tax payer; or submits a certificate from its banker of its or its promoter's track record where the applicant is neither a regulated entity nor an income tax payer;

- vii. the applicant has not been refused a certificate by SEBI;
- viii. whether the applicant is a fit and proper person.

SEBI may require the applicant to furnish further information, if it considers necessary. An application which is not complete in all respects is rejected by SEBI. However before rejecting any such application, it has been provided in the Regulations that the applicant should be given an opportunity to remove, within thirty days of the date of receipt of communication, the objections indicated by SEBI. SEBI may, on being satisfied that it is necessary to extend the period specified above may extend such period but not beyond ninety days.

#### **Procedure for grant of certificate**

If SEBI is satisfied that the applicant is eligible for the grant of certificate, it should send an intimation to the applicant and on the receipt of intimation, the applicant has to pay the registration prescribed fee. SEBI on receipt of the registration fee grants a certificate of registration.

#### **Procedure where certificate is not granted**

However after considering an application, if SEBI is of the opinion that a certificate should not be granted, it may reject the application after giving the applicant a reasonable opportunity of being heard. The decision of SEBI to reject the application should be communicated to the applicant. Any applicant whose application has been rejected should not carry on any activity as a Foreign Venture Capital Investor.

#### **Conditions of certificate**

The certificate to be granted to the foreign venture capital is subject to the the conditions that:

- i. it should abide by the provisions of the Act, and these regulations;
- ii. it should appoint a domestic custodian for purpose of custody of securities;
- iii. it should enter into arrangement with a designated bank for the purpose of operating a special non-resident rupee or foreign currency account;
- iv. it should forthwith inform SEBI in writing if any information or particulars previously submitted to SEBI are found to be false or misleading in any material particular or if there is any change in the information already submitted.

#### **Investment Criteria for a Foreign Venture Capital Investor**

All investments to be made by a foreign venture capital investors should be subject to the following conditions:

- a. it should disclose to SEBI its investment strategy.
- b. while it can invest its total funds committed in one venture capital fund it should however not invest more than 25% of the funds committed for investments to India in one Venture Capital Undertaking.
- c. it should make investments in the Venture Capital Undertaking as enumerated below:
  - i. atleast 75% of the investible funds should be invested in unlisted equity shares or equity linked instruments.
  - ii. not more than 25% of the investible funds may be invested by way of:

- a. subscription to initial public offer of a venture capital undertaking whose shares are proposed to be listed subject to lock-in period of one year;
- b. debt or debt instrument of a venture capital undertaking in which the foreign venture capital investor has already made an investment by way of equity.

### **Maintenance of books and records**

Every Foreign Venture Capital Investor is required to maintain for a period of eight years, books of accounts, records and documents which should give a true and fair picture of the state of affairs of the Foreign Venture Capital Investor. Every Foreign Venture Capital Investor should intimate to SEBI, in writing, the place where the books, records and documents are being maintained.

### **Power to call for information**

SEBI may at any time call for any information from a Foreign Venture Capital Investor with respect to any matter relating to its activity as a Foreign Venture Capital Investor. In case any information is called for, it should be furnished within the time specified by SEBI.

### **General Obligations and Responsibilities**

Foreign Venture Capital Investor or a global custodian acting on behalf of the foreign venture capital investor should enter into an agreement with the domestic custodian to act as a custodian of securities for Foreign Venture Capital Investor. Foreign Venture Capital Investor should ensure that domestic custodian takes steps for monitoring of investment of Foreign Venture Capital Investors in India, furnishing of periodic reports to SEBI and furnishing such information as may be called for by SEBI.

### **Appointment of Designated bank**

Foreign Venture Capital Investor is required to appoint a branch of a bank approved by Reserve Bank of India as designated bank for opening of foreign currency denominated accounts or special non-resident rupee account.

### **Inspection or investigation**

SEBI may, suo-moto or upon receipt of information or complaint, cause an inspection or investigation to be made in respect of conduct and affairs of any foreign venture capital investor by an Officer whom SEBI considers fit:

- i. to ensure that the books of account, records and documents are being maintained by the foreign venture capital investor in the manner specified in these regulations and to inspect or investigate into complaints received from investors, clients or any other person, on any matter having a bearing on the activities of the foreign venture capital investor;
- ii. to ascertain whether the provisions of the Act and these regulations are being complied with by the foreign venture capital investor and to inspect or investigate suo-moto into the affairs of a foreign venture capital investor in the interest of the securities market or in the interest of investors.

### **Obligations of Foreign Venture Capital Investor**



It should be the duty of every Foreign Venture Capital Investor in respect of whom an inspection or investigation has been ordered and any other person associated who is in possession of relevant information pertaining to conduct and affairs of such Foreign Venture Capital Investor including asset management company or fund manager, to produce to the Inspecting or Investigating Officer such books, accounts and other documents in his custody or control and furnish him with such statements and information as the said officer may require for the purposes of the inspection or investigation. It should be the duty of Foreign Venture Capital Investor and any other person associated who is in possession of relevant information pertaining to conduct and affairs of the Foreign Venture Capital Investor to give to the Inspecting or Investigating Officer all such assistance and shall extend all such co-operation as may be required in connection with the inspections or investigations and shall furnish such information sought by the Inspecting or Investigating Officer in connection with the inspections or investigations. The Inspecting or Investigating Officer have the power to examine on oath and record the statement of any person responsible for or connected with activities of Foreign Venture Capital Investor or any other person associated having relevant information pertaining to such Foreign Venture Capital Investor. The Inspecting or Investigating Officer has the power to get authenticated copies of documents, books, accounts of Foreign Venture Capital Investor, from any person having control or custody of such documents, books or accounts. The Inspecting or Investigating Officer submits a report to SEBI after the completion of inspection or investigations.

### **Powers of SEBI**

SEBI after considering investigation report and giving a reasonable opportunity of hearing to the Foreign Venture Capital Investor, require the Venture Capital Fund to take such measure or issue such directions as it deems fit in the interest of capital market and investors, including directions requiring the person concerned to dispose of the securities or disinvest in a manner as may be specified in the directions; or requiring the person concerned not to further invest for a particular period; or prohibiting the person concerned from operating in the capital market in India for a specified period.

### **Suspension/Cancellation of certificate**

SEBI after considering the investigation report, initiate action for suspension or cancellation of the registration of such Foreign Venture Capital Investor. However no such certificate of registration shall be suspended or cancelled unless the procedure specified in regulation has been complied with.

SEBI may suspend the certificate if the Foreign Venture Capital Investor contravenes any of the provisions of the Act or these regulations or fails to furnish any information relating to its activity as a Foreign Venture Capital Investor as required by SEBI or furnishes to SEBI information which is false or misleading in any material particular or does not submit periodic returns or reports as required by SEBI or does not co-operate in any

enquiry or inspection conducted by SEBI.

SEBI may cancel the certificate granted to a Foreign Venture Capital Investor if the Foreign Venture Capital Investor is guilty of fraud or has been convicted of an offence involving moral turpitude. Also SEBI may cancel the certificate if the Foreign Venture Capital Investor has been guilty of repeated defaults of the nature mentioned in the regulation or Foreign Venture Capital Investor does not continue to meet the eligibility criteria laid down in the regulations or contravenes any of the provisions of the Act or regulations.

### **Enquiry under the Regulations**

No order of penalty or cancellation of certificate should be imposed on the Foreign Venture Capital Investor except after holding an enquiry in accordance with the procedure specified in the regulation.

### **Manner of holding enquiry before suspension or cancellation**

For the purpose of holding an enquiry, SEBI may appoint one or more enquiry officers. The enquiry officer should issue a notice to the Foreign Venture Capital Investors, at its registered office or its principal place of business or its agent or representative in India, setting out the grounds on which action is proposed to be taken against it and calling upon it to show cause against such action within a period of fourteen days from the date of receipt of the notice. The Foreign Venture Capital Investor may, within fourteen days from the date of receipt of such notice, furnish to the enquiry officer a written reply, together with copies of documentary or other evidence relied on by it or sought by SEBI from the Foreign Venture Capital Investor. The enquiry officer should give a reasonable opportunity of hearing to the Foreign Venture Capital Investor to enable him to make submissions in support of its reply. The Foreign Venture Capital Investor can appear before the enquiry officer through any person duly authorised by the Foreign Venture Capital Investor. However no lawyer or advocate should be permitted to represent the Foreign Venture Capital Investors at the enquiry. It has been further provided that where a lawyer or an advocate has been appointed by SEBI as a presenting officer it should be lawful for the Foreign Venture Capital Investor to present its case through a lawyer or advocate.

The enquiry officer, if considers it necessary, may ask SEBI to appoint a presenting officer to present its case. The enquiry officer is required to submit a report to SEBI after taking into account all relevant facts and submissions made by the Foreign Venture Capital Investor, and recommend the penal action, if any, to be taken against the Foreign Venture Capital Investor as also the grounds on which the proposed action is justified.

### **Show-cause notice and order**

SEBI may on the report of the enquiry officer may issue to the Foreign Venture Capital Investor a show-cause notice as to why the penal action as proposed by the enquiry officer or such appropriate action should not be taken against it. Foreign Venture Capital Investor has to send a reply to SEBI within fourteen days of the date of the receipt of the show-cause

notice. SEBI, after considering the reply, if any, of the Foreign Venture Capital Investor pass such order as it deems fit.

### **Effect of suspension and cancellation of certificate**

The Foreign Venture Capital Investor should cease to carry on any activity on and from the date of the suspension of the certificate as a Foreign Venture Capital Investor during the period of suspension, and subject to such directions of SEBI with regard to any records, documents or securities that may be in its custody or control, relating to its activities as Foreign Venture Capital Investor, as SEBI may specify. The Foreign Venture Capital Investor should with immediate effect cease to carry on any activity on and from the date of cancellation of the certificate as a Foreign Venture Capital Investor, and should subject to such directions of SEBI with regard to the transfer of records, documents or securities that may be in its custody or control, relating to its activities as Foreign Venture Capital Investor, as specified by SEBI. The order of suspension or cancellation of certificate passed is required to be published by SEBI in two newspapers.

### **Appeal to Securities Appellate Tribunal**

Any person aggrieved by an order of SEBI may prefer an appeal to the Securities Appellate Tribunal.

### **LESSON ROUND-UP**

- Venture capital is the capital that is invested in equity or debt securities (with equity conversion terms) of young unseasoned companies promoted by technocrats who attempt to break new path.
- In India, Venture Capital is regulated by SEBI (Venture Capital Funds) Regulations, 1996
- A Venture Capital Fund (VCF) strives to provide entrepreneurs with the support they need to create up-scalable business with sustainable growth, while providing their contributors with outstanding returns on investment, for the higher risks they assume.
- Venture capitalists typically raise funds largely from investors such as financial institutions, banks, pension funds, corporations, endowments/foundations and high net-worth individuals.
- Foreign Venture Capital Investor means an investor incorporated and established outside India, which proposes to make investment in venture capital fund(s) or venture capital undertakings in India and is registered under SEBI(Foreign Venture Capital Investors) Regulations, 2000
- Incubators - An incubator is a hardcore technocrat who works with an entrepreneur to develop a business idea, and prepares a Company for subsequent rounds of growth & funding.
- Angel Investors - An angel is an experienced industry-bred individual with high net worth. Typically, an angel investor would invest only his chosen field of technology, take active participation in day-to-day running of the Company ,invest small sums in the range of USD 1-3 million not insist on detailed business plans sanction the investment in up to a month help company for “second round” of funding.Venture

### Capitalists (VCs)

- Venture Capitalists are organizations raising funds from numerous investors and hiring experienced professional managers to deploy the same.
- Private Equity Players- They are established investment bankers. They typically invest into proven/ established businesses. They have “financial partners” approach.
- Trust or a Company – It is a fund established in the form of a trust or a company including a body corporate and registered under SEBI Regulations which has a dedicated pool of capital, raised in a manner specified in the Regulations and invests in venture Capital undertaking.