IVCA
INDIAN PRIVATE EQUITY
& VENTURE CAPITAL ASSOCIATION

C-7, Pashchimi Marg, Vasant Vihar, New Delhi - 110057

25.04.2012

Shri H. R. Khan
Deputy Governor
Reserve Bank of India
Central Office
Mumbai 400 001

Dear Sir,

We are grateful to you for having spared your valuable time to meet with us in the past and for your patient hearing on the issues raised by us for your consideration. We are giving below for your review some issues concerning the guidelines by the RBI pertaining to VCF's and FVCI's.

1. Background

1.1 As you are aware, domestic venture capital funds ('VCF') and foreign venture capital investor ('FVCI') are presently regulated by the Securities Exchange Board of India ("SEBI") and the Reserve Bank of India ('RBI'). The primary regulations which regulate a VCF and a FVCI are the Securities and Exchange Board of India (Venture Capital Funds) Regulations, 1996 ("VCF Regulations") and the Securities and Exchange Board of India (Foreign Venture Capital Investor) Regulations, 2000 ("FVCI Regulations").

1.2 SEBI & the RBI, being the chief regulators, for the purposes of monitoring VCFs and FVCIs investment activities in India, have prescribed a number of investment conditions and restrictions, under the aforesaid regulations. For instance, in relation to VCFs/FVCIs, SEBI has prescribed certain activities and sectors in the negative list (such as non banking financial companies, gold financing, activities restricted under the industrial policy etc.), in which investments by VCFs/FVCIs are not permitted.

1.3 In addition to the above restrictions contained in the aforesaid regulations, separately the Income Tax Act ('ITA') provide for a 'pass through' status for tax purposes, to VCFs, if investments are made by such VCFs in Indian Venture Capital Undertakings ('IVCU') engaged in only nine specified sectors (as set out in Annexure A). Considering the tax benefits associated with these nine sectors, this operates as an additional restriction on investments by VCFs, outside the SEBI/RBI regime.

1.4 In order to bring parity with the restrictions imposed on VCFs under the ITA, we understand that the RBI has, while approving FVCI registrations, in the past instructed the Indian custodians of FVCIs that investments by the FVCI have to be restricted to the nine specified sectors stated in Annexure A.

1.5 The restrictions imposed under the ITA, being in addition to the restrictions imposed under the VCF Regulations and the FVCI Regulations has limited necessary growth capital for the small and medium enterprises in the sectors other than the nine specified sectors. Further, the concurrent prevalence of multiple sets of guidelines / requirements by different regulators has created inconsistencies and undesirable uncertainties.

1.6 In any event, as is commonly known across the world, sectoral restrictions for venture capital investments are inconsistent 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 main objective of venture capital is to provide risk capital. Sectoral restrictions create unnecessary obstacles and hamper growth. However, certain restrictions specifying a negative list including activities not legally permitted are justifiable.

1.7 Recognizing the need to remove multiplicity of conditions in different regulations for the same entities, on March 16, 2012, Hon'ble Minister of Finance, Mr. Pranab Mukherjee, in his speech for the budget 2012-2012, mentioned that the restrictions on venture capital funds to invest only in nine specified sectors is proposed to be removed. The relevant provisions of the Finance Bill, 2012 is extracted below for your reference:

'Section 10(23FB) further provides that income of a SEBI regulated VCF or VCC, derived from investment in a domestic company i.e. Venture Capital Undertaking (VCU), is exempt from taxation, provided the VCU is engaged in only nine specified businesses. The working of VCF, VCC or VCU are regulated by SEBI and RBI. In order to avoid multiplicity of conditions in different regulations for the same entities, the sectoral restriction on business of VCU is required to be removed from Income Tax Act and such VCU is to be allowed to be governed by conditions imposed by SEBI and RBI.

1.8 Needless to say, the government's initiative comes as a big relief to the venture capital industry and would increase capital flow into higher growth sectors that have substantial capital requirements.

2. Request

2.1 Considering the positive step taken by the government to remove the said restrictions under the ITA, likewise the RBI should also no longer consider the erstwhile list under the ITA as a restriction on VCFs and FVCI's ability to invest in India. The only applicable negative list should thus be the list set out in the relevant SEBI Regulations. Such an approach will bring much needed parity between the VCFs and the FVCI and will indeed send a strong positive message to the offshore investing community.

2.2 As the said restrictions on VCFs have now been proposed to be done away with, it is only logical to extend the same to FVCIs as well.

2.3 In line with the revised regime for VCFs, a single regulatory requirement for FVCIs, would provide the much needed investment and operational flexibility to FVCIs, make the perception of foreign investors positive and create the required environment for increased flow of funds and growth of venture capital industry in India. Continuance of additional restrictions on investments by FVCIs (as compared to VCFs), in addition to affecting venture capital transactions and investment in India, will also send worrying signals to international venture capital investors, which certainly cannot be the intention of RBI.

2.4 Venture Capital has been contributing significantly as a percentage of foreign investment in the country during the last few years. Further the FVCI route is only available to sophisticated investors/funds who are registered with RBI (which registration is subject to a number of eligibility criteria's/minimum qualifications), which in addition to financing, also provide additional value including management support and other skills that facilitates the conversion of entrepreneurial visions to marketable products. Therefore, the removal of sectoral restrictions would also not create any abusive arbitrage between investments through the FDI route and investments through the FVCI route.

2.5 We trust that, you will give due consideration to our suggestions and in furtherance of the spirit of the relaxation accorded by the Finance Minister to VCFs, RBI would withdraw its previous instructions issued to various Indian custodians of FVCIs providing for additional restrictions on investments by FVCI to the nine specified sectors stated in Annexure A.

Executive Committee Members of the IVCA also seeks an appointment with you any time convenient to you. Kindly do give us an opportunity to provide you with clarifications and the industry perspective.

Thank you.

Yours sincerely,

Mahendra Swarup
President
For Indian Venture Capital Association of India

Annexure A

LIST OF NINE SPECIFIED SECTORS

(a) Developing or operating and maintaining or developing, operating and maintaining any infrastructure facility;

(b) Biotechnology;

(c) Information Technology related to hardware and software development;

(d) Nanotechnology;

(e) Seed Research and Development;

(f) Research and Development of new chemical entities in pharmaceutical sector;

(g) Dairy Industry;

(h) Poultry Industry;

(i) Production of Bio-fuels;

(j) Building and operating composite Hotel-cum-Convention Centre (with seating capacity of more than 3000).