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New rules complicate FDI status of venture capital investments

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New DelhiThe changes in the foreign investment rules could prompt venture capital funds to review or delay their investment, besides creating confusion over their existing investments.

Since most venture funds are set up as trusts under the Indian Trusts Act 1882, wherein ownership and control are not defined unlike in the Companies Act 1956, it is unclear whether or not the government will treat their investment as FDI.

The Securities & Exchange Board of India (Sebi) rules allow venture funds to invest up to a third of their capital in listed companies.

Venture funds can be set up as trusts and companies. About 99% of the venture funds are floated as trusts to save on dividend distribution taxes, which have to be paid by a company, said BMR & Associates partner Abhisek Goenka.

Complications arise since trusts have only beneficiaries, and not owners, which makes it hard to say who owns a venture capital trust, especially if it has non-resident beneficiaries. "Things are fine if the venture fund is a company. But the treatment of investment by venture funds established as trusts, and having non-resident partners, is not clear," Goenka said.

The new FDI guidelines would not impact foreign venture capital funds. Since they will be treated as non-resident entities, any investment by them will be counted as foreign investment. But, for domestic venture trusts with non-resident investors, the government has to firm up the ownership and control criteria. The other option, preferred by the industry, is to exempt them from the revised norms.

The domestic venture capital funds are required to have a capital base of at least Rs 5 crore.

"Many domestic venture capital and private equity funds have foreign investment. The main problem is in how control and ownership are defined," said Saurabh Srivastava, chairman of Delhi-based Indian Venture Capital Association.

However, some experts argue that the new rules will not impact trusts.

"Currently, Press Note 2 of 2009 (which details the new FDI norms) is applicable to Indian investing companies and does not envisage any form of entity other than a company. Accordingly, as per the literal interpretation of Press Note 2, VC funds set up as trusts may not get impacted by the Press Note," said Richie Sancheti, associate, Nishith Desai Associates.

In 2007, total VC and PE investments in India were at \$19.5 billion, but in 2008 it came down to around \$15 billion, as per data maintained by the association. Of this, 80% funds were from abroad and 20% from Indian sources. The Indian VC industry is very small in comparison to foreign funds operating in India, said Shailesh Vickram Singh, director, 2i Capital (India) Pvt Ltd. Domestic VCs should be having a maximum of \$1 billion in investments, he said.

"The foreign investment in VC funds set up as trusts is anyway subject to FIPB approval unless it is made by a registered FVCI entity, and hence, FIPB may stipulate that the VC fund in India will have to comply with the FDI norms for any down-the-line investment", Sancheti said.