



INDIAN JOURNAL OF
LEGAL REVIEW

VOLUME 4 AND ISSUE 3 OF 2024

INSTITUTE OF LEGAL EDUCATION



INDIAN JOURNAL OF LEGAL REVIEW

APIS – 3920 – 0001 | ISSN – 2583-2344

(Free and Open Access Journal)

Journal's Home Page – <https://ijlr.iledu.in/>

Journal's Editorial Page – <https://ijlr.iledu.in/editorial-board/>

Volume 4 and Issue 3 of 2024 (Access Full Issue on – <https://ijlr.iledu.in/volume-4-and-issue-3-of-2024/>)

Publisher

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GROWTH OF VENTURE CAPITAL FUNDS IN THE SECURITIES MARKET IN INDIA

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BEST CITATION – RAHEN SARDAR, GROWTH OF VENTURE CAPITAL FUNDS IN THE SECURITIES MARKET IN INDIA, INDIAN JOURNAL OF LEGAL REVIEW (IJLR), 4 (3) OF 2024, PG. 606-611, APIS – 3920 – 0001 & ISSN – 2583-2344.

Abstract:

The development and increase in the number of Venture Capital funds in the Indian securities market have contributed much to innovation and entrepreneurship. This research article examines the evolution of VC in India, starting from its inception to the present times, considers the legal framework within which it is constrained to operate, and analyses various factors that have been responsible for its growth. The early 2000s really saw the beginning of a more structured VC landscape in India, spurred on by regulatory support from entities like the Securities and Exchange Board of India. Trends in the very recent past have shown strong growth in VC investments, especially in technology-driven sectors, proving just how vibrant this burgeoning ecosystem is turning out to be.

In this context, the Indian GDP growth, technological advancement, and supportive governmental policies have triggered the VC sector significantly. However, there are a lot of challenges regarding market volatility, regulatory complexities, and stiff competition provided by alternative sources of funding.

I. Introduction:

Venture Capital has emerged as a critical driver of innovation and entrepreneurship in India's rapidly changing securities ecosystem. Over the past two decades, the Indian VC ecosystem has had active growth on account of economic, technological, and regulatory factors all combined.

As per section 2(m) of SEBI (VENTURE CAPITAL FUNDS) REGULATIONS, 1996, "venture capital fund" means a fund established in the form of a trust or a company including a body corporate and registered under these regulation which—

- (i) has a dedicated pool of capital;
- (ii) raised in a manner specified in the regulations, and
- (iii) invests in accordance with the regulations;

Venture capital essentially refers to the finance of young, often small businesses with tremendous growth prospects at their early

stages against equity shares. Starting early in the 2000s, India saw the VC industry take more solid shape, with key regulatory frameworks being created and some key VC firms entering. The Securities and Exchange Board of India played a very dynamic role in making things easier for VC investments by issuing guidelines and regulations that would protect investors and ensure transparency in the market.

Continuous growth in VC in India saw the highest-ever VC funding of \$38.5 billion in 2021, which indeed was a growth of 3.8x over. Undoubtedly, such high funding is in correlation with an increase in numbers and growing interest by both domestic and international investors in the Indian market. While funding was down slightly in 2023, deals continued to rise with investments reaching \$25.7 billion, reflecting sustained investor confidence in the Indian startup ecosystem. Several factors have contributed to the development of VC in India: its robust economic growth, the advancement

of technology, and very friendly government policies. The Indian Government has established several programs to encourage entrepreneurship and innovation, such as the establishment of the Startup India initiative, funding opportunities, mentorship programs, and tax benefits for startups. Finally, a few industries that are driven by technology, like financial technology, e-commerce, and healthcare, have become the main recipients of VC and, hence, highly contributing to the industry's development.

But the Indian VC landscape is strewn with challenges such as market volatility, regulatory complexities, and competition from alternative sources of funding. Nevertheless, the future outlook for VC in India is bright as emerging sectors begin to show potential and investor interest is at an all-time high, with heightened fuel toward continued growth.

II. Historical Background:

The history of Indian venture capital thus becomes an exciting journey of the evolution of the country's economic change and the rise in the importance of innovation and entrepreneurship. The roots of VC in India date back to the mid-1980s, a period of economic liberalization. The Indian government initiated the process of opening up the economy in 1986, whence the formal establishment of venture capital began.

In 1988, the Indian government brought out a set of guidelines to institutionalize venture capital, which probably has been the most important milestone in the development of the VC industry. The stipulated guidelines were meant for putting a structured framework regarding investments by the VC firms to maintain complete transparency in safeguarding the interests of the investors. Initially, VC activities were limited to subsidiaries set up by institutions such as the Industrial Development Bank of India (IDBI), the Industrial Credit and Investment Corporation of India (ICICI), and the Industrial Finance Corporation of India (IFCI).

During the initial years of the VC, it was large industrial concerns that seemed to be its target area for providing risk capital to such enterprises for growth and development. The late 1990s saw the changing scenario with more dynamic and diverse VC firms emerging. This ushered in a fresh spurt that took place in formal VC markets and gave birth to new industries and saw the emergence of entrepreneurial venture growth.

The turn of the century saw a sea-change in the VC landscape in India. Strong economic growth of the country—an annual GDP eld of around 8.5-9% during 2000-09—attracted global VC funds to India. Many General Partners raised India-focused funds amply recognizing the potential of the Indian market. This, in turn, was reinforced by global capital inflow into the VC industry in India, giving much-needed funds to a number of startups and small businesses with high growth potential.

Some key regulatory regimes were set up in the early 2000s, which also marked the entry of some prominent VC firms. The Securities and Exchange Board of India introduced guidelines and regulations towards creating an apt environment for VC investments, ensuring transparency and investor protection. This was together with the interest from both domestic and international investors; eventually, this regulatory support led to a radical ramp-up in the level of VC funding in India.

Over the past fifteen years, the venture capital industry in India has continued to evolve. It has been observed that technologically driven sectors like fintech, e-commerce, and healthcare attract much interest. The government initiatives like the Startup India program further catalyses the VC ecosystem with funding, mentorship, and tax benefits to the startups.

III. Legal Framework:

Basically, the legal framework for VC funds in India is set by the Securities and Exchange Board of India, playing a very elemental role in regulating and promoting the industry of

venture capital. The SEBI (Venture Capital Funds) Regulations, 1996, were the first set of regulations specifically designed to govern VC activities in India. These regulations, therefore, prescribe the eligibility criteria of establishment and operation of VC funds: registration with the SEBI, investment criteria, and disclosure norms.

Outside the SEBI regulations, the legal framework for VC funds was further refined by the SEBI (Alternative Investment Funds) Regulations, 2012. In terms of these regulations, VC funds were classified under one category in a broad category called Alternative Investment Funds. AIFs are categorized into three parts or categories: Category I (including VC fund), Category II (including private equity fund), and Category III (including hedge fund). Category I AIFs include VC funds and are considered to have positive spillover effects on the economy, enjoying some tax benefits.

.As per SEBI regulations, VC funds are to be established only as a trust, body corporate, or an LLP and to be registered with SEBI. The regulations also detail the investment criteria for VC funds—for instance, the requirement for a minimum 66% of their corpus to be invested in unlisted equity shares or equity-linked instruments of startups and early-stage companies. More importantly, VC funds are required to display certain levels of transparency and disclosure, including facilitating periodic reporting to SEBI and investors.

The Foreign Venture Capital Investors Regulations, 2000, provide a way for foreign investors to invest in Indian startups and small enterprises. Similar to domestic VC funds, foreign VC investors will be permitted to invest in Indian companies without prior registration with SEBI, provided they are eligible under the FVCI regulations. The FVCI regulations offer tax efficiencies for foreign investors, making India a very attractive location for global VC funds.

The legal framework for VC in India is designed to be conducive to innovation and enterprise, with the added assurance of investor protection

and market transparency. Such SEBI regulations and other legal provisions are major facilitators of the VC industry's growth in recent times, helping the scalability and success of startups by providing them with much-needed funds and support.

IV. Current State of Venture Capital in India

Over the last decade, India's VC landscape has grown and transformed to a significant extent, placing the country in a leading position within the global startup ecosystem. Despite all the recent challenges, the ecosystem continues to be buoyant, powered by strong startup culture and government policies.

VC funding in India moderated to \$9.6 billion in 2023 from \$25.7 billion in 2022, reflecting a global caution on risk capital as inflation is prolonged while interest rates remain high. India retained its position as the second-largest Asia-Pacific destination for VC and growth funding.

There was a meteoric rise in the number of startups in the Indian ecosystem, while sectors like fintech, e-commerce, and healthcare attracted much VC investment. Government initiatives like the Startup India program further helped the VC ecosystem in funding, mentorship, and tax benefits.

Large VC firms actively investing in India include Sequoia Capital, Accel, and Tiger Global. Their role extends beyond providing financial support to strategic guidance, networking opportunities, and operational support provided to portfolio companies.

Despite all these challenges, the future of VC in India remains bright. Artificial intelligence, blockchain, and renewable energy are some up-and-coming sectors that are expected to see the highest VC investments in the near term, hence sustaining the recent growth of the sector. The resilient Indian startup ecosystem, backed by conducive government policies and a growing pool of domestic and international investors, has positioned India as a key destination for VC funding.

V. Factors Driving Growth of Venture Capital in India

In turn, this fuels the growth of venture capital in India for various reasons: economic, technological, and policy-related. All these aspects have come together to create a facilitative atmosphere for startups and investors, thus giving rise to a thriving and dynamic VC ecosystem.

A. Economic Factors

Robust economic growth has been the principal propeller of VC investments in India. Consistently, one of the highest GDP growth rates in the world created a very favorable ecosystem for business expansion and innovation. This post-pandemic recovery of the economy, led by increased consumer demand and supported by government stimuli, further strengthened corporate earnings and market confidence.

B. Technological Advancements

Needless to say, technological advancement has played a very important part in the growth curve of VC in India. To begin with, it is the digital connectivity that has reached even the remotest parts of India, proliferation of smartphones, and increasing usage of new technologies such as artificial intelligence, blockchain, and renewable energy—these have opened new vistas for startups. Most of these technology innovations attracted substantial VC investments in start-ups, especially in the fintech, ecommerce, and healthcare sectors.

C. Government Policies and Incentives

The Government of India has implemented some policies and programs toward promoting better entrepreneurship and innovation. The Startup India initiative, which began in 2016, has fostered new ventures with support from funding, mentorship, and tax benefits. The much-needed infrastructural development and growth in manufacturing and digitalization received a fillip with various new schemes, further improving the investment climate.

D. Emergence of the Startup Ecosystem

This has, to an extent, been driven by the fast-growing startup ecosystem in India. India is one of the largest startup hubs globally, with over 92,000 startups within the country. VC funding saw a surge driven by growing numbers of startups and rising interest from domestic and international investors. Investments from firm steps by prominent firms like Sequoia Capital, Accel, and Tiger Global have maintained a strong hold on VC firms, providing Indian-founded startups with financial support apart from strategic leaps and operational guidance.

E. Global Investor Interest

The Indian market has been of immense interest to the global investor community, promising high returns and growth at a very rapid pace. Foreign VC investors have been assured of an active start-up ecosystem in India, which again is facilitating the easy inflow of capital and expertise. FVCI Regulations, 2000, have encouraged foreign investment with tax benefits and the relaxation of regulatory requirements.

VI. Challenges and Risks in Venture Capital in India

Indian VC, while on a growth trajectory, also has its challenges and risks pertaining to sustainability and effectiveness. These are multi-dimensional in nature: regulatory hurdles, market volatility, competition from other sources of alternate funding, and exit issues.

A. Regulatory Hurdles

Among these broad sets of challenges, the tricky regulatory environment prevails as one of the major challenges within the VC landscape. SEBI has introduced regulations governing the activities of VC firms; though startups and VC firms often face bureaucratic delays and compliance issues. What is really needed is streamlined and more startup-friendly regulations that can facilitate a more conducive atmosphere for VC investments.

B. Market Volatility

The other major risk to VC investments is market volatility. Economic fluctuations, changes in

investor sentiment, and other global economic conditions may affect the availability of risk capital. Recently, in 2023, VC funding declined to \$9.6 billion from \$25.7 billion as global economic factors found their way into affecting the Indian VC market.

C. Competition to Alternative Sources of Funding

VC firms in India are in heavy competition with alternative sources of funding, such as private equity, debt financing, and crowdfunding. Most of these options come with better deals and faster ways of raising capital, hence giving VC firms a hard time in winning and retaining the attention of startups.

D. Exit Concerns

This, therefore, makes the exit strategies of VC investors a very vital part of the investment life cycle. Still, the search for good exit opportunities like IPOs or acquisitions is quite difficult in the Indian market. The absence of sufficient mechanisms for exit will further discourage investors from commitment to capital to VC funds.

VII. Conclusion

VC funds have grown as a transformative force in the securities market in India. This has brought a high degree of impact both on the startup ecosystem and on the wider economy at large. From its nascent stages of the 1980s, VC today stands as a vibrant sector that fuels innovation, nurtures entrepreneurship, and contributes to economic progress. It is the legal framework provided by SEBI, together with policies enacted by the government such as Startup India, that has established an environment for VC investments marked by transparency and protection of investor interest, which finally becomes an innovative culture.

Strong economic performance, technology development potential, and enabling policies have combined to drive growth in India. It is for this reason that, of late, much domestic and global investor interest has been generated due to the country's vibrant ecosystem, which

fosters a high increase in VC funding across fintech, e-commerce, insurance, and healthcare. While these are the positive indicators, regulatory challenges, market volatility, and alternatives to finance provide a broader overview to this growth, and there is, therefore, a need for further reforms and strategic interventions to facilitate even more growth.

These challenges notwithstanding, the outlook for VC in India remains very positive. New sectors such as artificial intelligence, blockchain, and renewable energy provide new avenues that are attracting VC investments. Resilience in the Indian economy, supported by favorable government policy and global investor interest, makes India a key VC destination.

The VC stakeholders—investors, entrepreneurs, and policymakers—aim at sustained growth and success of the VC ecosystem in India once there is mitigation of challenges and capitalization on opportunities. This will form a comprehensive analysis of the critical role venture capital plays in driving innovation and economic growth, offering key insights for future research and policy formulation.

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