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Title- Venture Capital in India a critical analysis of the legal and regulatory framework

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Abstract

Venture capital has become an important source of finance for innovative and high-growth businesses in India, particularly for startups whose early-stage funding requirements may not be adequately served by conventional debt finance. Unlike ordinary lending, venture capital generally involves an investment in the ownership or ownership-linked interests of a business, together with an expectation of long-term growth and an eventual exit. The legal character of a venture capital transaction therefore extends beyond the act of investing money and involves fund regulation, corporate law, foreign exchange rules, taxation, securities regulation, contractual rights and insolvency considerations. This paper examines the Indian legal and regulatory framework governing venture capital, with particular attention to the SEBI (Alternative Investment Funds) Regulations, 2012¹, the Companies Act, 2013, FEMA and the regulations governing foreign investment and foreign venture capital investors. It also considers the importance of term sheets, shareholder agreements, valuation, investor protection and exit rights. The paper identifies regulatory complexity, contractual imbalance, valuation uncertainty, compliance costs and exit-related difficulties as important practical concerns. It further examines recent regulatory developments, including the continuing evolution of the AIF framework and the removal of the angel-tax provision under section 56(2)(viib) from 1 April 2025.² The paper concludes that the Indian framework has developed substantially, but greater regulatory clarity, predictable compliance requirements and stronger coordination

¹ Securities and Exchange Board of India (Alternative Investment Funds) Regulations, 2012, regs. 2(1)(b), 3, 10–18 (India), as amended through July 14, 2026.

² Finance (No. 2) Act, 2024, § 13 (India) (omitting § 56(2)(viib) of the Income-tax Act, 1961, with effect from Apr. 1, 2025).

between legal regimes would make venture capital transactions more efficient while preserving investor and startup protections.

Keywords: Venture Capital, Startups, Alternative Investment Funds, Companies Act 2013, SEBI, FEMA, Foreign Venture Capital Investor, Startup Funding, Regulatory Framework

I. Introduction

Venture capital is a form of equity-oriented financing³ in which investors provide capital to businesses that have significant growth potential, usually in exchange for an ownership interest or an instrument linked to ownership. The concept developed internationally as a response to the financing needs of businesses that were innovative but lacked the established assets, cash flows or credit history normally required for conventional bank finance. In India, venture capital developed during the period of economic and financial reforms and has become closely associated with the growth of the startup ecosystem.

The importance of venture capital lies not only in the availability of funds. Venture capital investors may also contribute commercial experience, industry knowledge, strategic guidance, networks and assistance with future fundraising. Startup India describes venture capital funds as professionally managed investment funds that invest in high-growth startups and notes that such investors may participate actively through mentorship and strategic engagement. This makes venture capital different from a conventional creditor relationship in which the lender generally expects repayment with interest.

At the same time, venture capital creates a relationship in which the interests of founders and investors may not always be identical. Investors may seek board representation, information rights, reserved matters, anti-dilution protection, liquidation preferences and contractual exit mechanisms. Founders, on the other hand, may wish to retain management control and sufficient flexibility to operate and expand the business. The legal structure of a venture capital investment must therefore balance capital formation with corporate governance and protection of the interests of different stakeholders.

The legal framework in India is not contained in a single statute. Venture capital transactions may involve the Companies Act, 2013, SEBI's regulatory framework for Alternative Investment Funds, FEMA and foreign investment rules, taxation laws, insolvency law and

general contract and intellectual property principles. The applicable requirements also depend on the identity of the investor, the legal form of the startup, the instrument used for investment, whether the investor is resident or non-resident, and the intended exit route.

The central issue examined in this paper is whether India's legal and regulatory framework facilitates genuine venture capital investment while maintaining adequate safeguards against misuse, unfair dilution, regulatory arbitrage and governance failures. The paper therefore considers both the statutory framework and the practical relationship between investors and startups.

Research Objectives

- To explain the concept, characteristics and economic significance of venture capital in India.
- To examine the principal legal and regulatory provisions governing venture capital investments.
- To analyze the role of SEBI and the Alternative Investment Fund framework in regulating venture capital funds.
- To examine the Companies Act, 2013 provisions relevant to fundraising, issue of securities and corporate governance.
- To understand the relevance of FEMA and foreign investment rules to investments made by non-resident investors and foreign venture capital investors.
- To examine the contractual and governance issues arising between venture capital investors and startup founders.
- To identify practical legal and regulatory challenges and suggest measures for improving the venture capital framework.

Research Methodology

This paper adopts a doctrinal legal research methodology. The study is primarily based on statutory provisions, delegated legislation, SEBI regulations, RBI regulations and official government material. Relevant judicial decisions are used to understand principles relating to securities issuance, shareholder rights and corporate arrangements where they assist the analysis. The paper also considers official Startup India material to understand the practical structure of startup funding and venture capital transactions. The analysis is based on the legal position and regulatory material available up to September 2026.

II. Conceptual and Definitional Framework

A. Meaning and Nature of Venture Capital

Venture capital may broadly be understood as professionally managed investment capital directed towards businesses with substantial growth potential, especially businesses at an early or expansion stage. The investment is generally associated with equity or equity-linked instruments rather than a fixed repayment obligation. The investor accepts a higher degree of commercial risk in expectation of capital appreciation or another investment return at a later stage.

The relationship is therefore more than a simple financing arrangement. A venture capital investor may become an important corporate stakeholder and may obtain rights relating to management participation, access to information, major corporate decisions and future transfers of securities. The investment documents determine how these rights operate within the limits of company law and other applicable regulations.

B. Stages of Venture Capital Investment

Venture capital investment can occur at different stages of a startup's development. At the early stage, funding may be used for product development, proof of concept, recruitment and initial market entry. As the business develops, later rounds may finance expansion, technology development, new markets and scaling. Startup India identifies venture capital funding as particularly relevant at the early traction and later scaling stages, although the exact investment strategy differs among funds. [2]

The stage of investment affects the legal and commercial terms. An early-stage investment may involve greater uncertainty regarding valuation and business performance, while a later-stage investment may involve more extensive financial information, stronger governance rights and more clearly defined exit plans.

C. Venture Capital, Angel Investment and Private Equity

Venture capital should not be treated as identical to every form of private investment. Angel investors commonly invest their own capital, often at an earlier stage, whereas venture capital funds generally pool capital from investors and invest through a professionally managed fund structure. Private equity generally focuses on more mature businesses, although the distinction between private equity and venture capital may overlap in practice. The legal treatment depends

more on the investment vehicle, instrument and regulatory status than on the label used by the parties.

III. Legal and Regulatory Framework Governing Venture Capital in India

A. SEBI and the Alternative Investment Fund Framework

The Securities and Exchange Board of India is a central regulator for venture capital funds operating within the regulated Alternative Investment Fund framework. The SEBI (Alternative Investment Funds) Regulations, 2012 provide the principal regulatory framework for AIFs. Category I AIFs⁴ include venture capital funds and other specified funds that are considered to have a role in sectors or activities regarded as socially or economically desirable. The regulations govern matters such as registration, investment conditions, disclosure, governance, reporting and the conduct of the fund and its manager.

The AIF framework is significant because it moves venture capital from an informal investment model towards a regulated fund structure. Investors in a fund are able to commit capital under defined terms, while the fund manager operates subject to regulatory obligations. This improves transparency and investor protection, but compliance also creates costs that may be significant for smaller fund managers.

The regulatory framework continues to evolve. SEBI's regulations page records amendments to the AIF Regulations as recently as July 2026, and SEBI issued a Master Circular for AIFs in June 2026.⁵ This continuing development shows that the legal framework is being adjusted to address new fund structures, investor concerns and ease-of-doing-business issues.

B. Companies Act, 2013 and Raising Capital

The Companies Act, 2013 is important at the startup-company level because a venture capital investment commonly requires the issue or transfer of securities. For a private company, the relevant corporate process may include private placement under section 42, further issue of share capital under section 62, and the related rules and disclosure requirements. The precise provision depends on the nature and structure of the securities being issued.

⁴ Securities & Exchange Board of India (Alternative Investment Funds) Regulations, 2012, regs. 15–18.

⁵ Securities & Exchange Board of India (Alternative Investment Funds) Regulations, 2012, regs. 20–22.

The Act also establishes rules concerning the rights and responsibilities of directors, maintenance of corporate records, meetings and shareholder decision-making. These requirements matter because venture capital investors frequently negotiate governance rights that affect the composition and operation of the board. Contractual rights cannot simply be treated as independent of mandatory company-law requirements.

The legal position on private placement is particularly important. The Supreme Court's decision in *Sahara India Real Estate Corporation Ltd. v. Securities and Exchange Board of India*⁶ illustrates the significance of distinguishing a genuine private placement from an offer that legally amounts to a public issue. The case demonstrates that the manner in which securities are offered and the number and nature of offerees can have regulatory consequences. [4]

C. FEMA and Foreign Investment

Foreign investment adds another layer to venture capital transactions. Where a non-resident invests in an Indian startup, the parties must consider FEMA, the Foreign Exchange Management (Non-Debt Instruments) Rules, 2019 and the applicable RBI regulations and reporting requirements. The legal analysis may involve the sector in which the startup operates, the permitted foreign investment route, applicable investment limits, pricing requirements and reporting.

RBI's Foreign Exchange Management framework regulates the mode of payment and reporting for investments in Indian securities by persons resident outside India⁷. Accordingly, a transaction involving a foreign venture capital investor cannot be analysed only as a company-law investment; the foreign exchange implications must also be examined before the transaction is completed.⁸

D. Foreign Venture Capital Investors

Foreign venture capital investment has historically been subject to a dedicated regulatory framework under SEBI's Foreign Venture Capital Investors Regulations, 2000, alongside the broader foreign investment regime. The regulatory framework has evolved as the AIF regime

⁶ **Sahara India Real Estate Corp. Ltd. v. Securities & Exchange Board of India**, (2013) 1 SCC 1 (India).

⁷ Foreign Exchange Management (Mode of Payment and Reporting of Non-Debt Instruments) Regulations, 2019, regs. 3–4 (India).

⁸ Foreign Exchange Management Act, 1999, No. 42 of 1999, § 6 (India); Foreign Exchange Management (Non-Debt Instruments) Rules, 2019, rr. 4–5 (India).

has developed. SEBI's current regulations listing shows that the Foreign Venture Capital Investors Regulations, 2000 were amended as recently as July 2026.⁹

For transaction planning, the important point is that the identity and regulatory status of the foreign investor affect the permissible investment route and the compliance obligations. Counsel must therefore examine the fund's status, the target's sector, the instrument, applicable investment conditions and reporting requirements before the investment is structured.

E. Taxation and the Removal of Angel Tax

Tax considerations have traditionally been important in startup financing, particularly in relation to the valuation of shares issued by closely held companies¹⁰. A significant recent change is the removal of section 56(2)(viib) of the Income-tax Act¹¹, commonly referred to as the angel-tax provision, with effect from 1 April 2025. Startup India records this change as part of the regulatory reforms affecting startups.

The change reduces one specific tax concern associated with share issuance at a valuation above the prescribed fair-value parameters. It does not, however, remove the need for proper valuation, documentation, tax compliance or examination of other applicable provisions. Valuation remains important for commercial negotiations, corporate records, foreign investment rules and investor protection.

F. Insolvency and Exit Considerations

The Insolvency and Bankruptcy Code, 2016 is relevant when a startup faces financial distress. Venture capital investors are generally equity investors and therefore do not automatically enjoy the same position as secured creditors. The consequences of insolvency depend on the legal character of the instrument and the rights of the parties. This makes careful structuring of investment instruments and understanding of the insolvency waterfall important for both investors and founders.

Exit is a central part of venture capital economics. Common routes may include a strategic sale, sale to another financial investor, an initial public offering, a permitted buyback or another legally valid transfer. The investment documents often address these possibilities through

⁹ Securities & Exchange Board of India (Foreign Venture Capital Investors) Regulations, 2000, as amended through July 10, 2026 (India)

¹⁰ Income-tax Act, 1961, No. 43 of 1961, § 56(2)(viib) (India).

¹¹ Finance (No. 2) Act, 2024, No. 15 of 2024, § 23 (India).

transfer rights, drag-along and tag-along rights, rights of first refusal and other mechanisms, subject to applicable law.

IV. Investment Process and Key Legal Documents

A. Due Diligence

Before investing, venture capital investors generally conduct legal, financial and commercial due diligence. Legal due diligence may cover incorporation documents, shareholding, material contracts, intellectual property, employment matters, litigation, regulatory licences, data protection, tax compliance and previous fundraising. The purpose is to identify liabilities and confirm whether the business being presented to the investor is legally and commercially capable of receiving the proposed investment.

B. Term Sheet

A term sheet records the principal commercial terms proposed for the investment. Startup India's official material identifies valuation, investment structure, management structure and changes to share capital as important components of a venture capital term sheet. [8] Although a term sheet is generally intended to guide the parties towards definitive documents, particular provisions may be expressly binding, such as confidentiality, exclusivity or costs.

C. Shareholders' Agreement and Investment Agreement

The definitive investment documents translate the commercial agreement into enforceable contractual rights and obligations. Depending on the transaction, the documents may cover the number and class of securities, price, representations and warranties, conditions precedent, governance rights, information rights, reserved matters, transfer restrictions, anti-dilution protection, founder obligations, confidentiality, non-compete or non-solicit provisions where legally enforceable, and exit arrangements.

A key drafting issue is the relationship between contractual rights and mandatory corporate law. A provision that appears commercially attractive to an investor may still need to be implemented through a lawful corporate mechanism. Careful drafting is therefore necessary to avoid conflicts between the investment agreement, the articles of association and statutory requirements.

V. Governance and Investor Protection

A. Board and Decision-Making Rights

Venture capital investors may seek board representation or observer rights because investment decisions are closely connected with governance and monitoring. Reserved matters can require investor consent for specified actions such as issuing new securities, changing the capital structure, entering major transactions, altering the business model or undertaking related-party transactions. Such rights can protect the investor from material changes that could affect the value of the investment.

B. Founder and Minority Protection

The relationship also requires protection of founders and other shareholders. Excessively broad investor controls may restrict the founders' ability to manage the company, while insufficient investor protections may make high-risk investment commercially unattractive. A balanced agreement should therefore clearly identify matters requiring consent and distinguish them from ordinary business decisions.

C. Valuation and Dilution

Valuation is one of the most sensitive aspects of venture capital financing. A startup may have significant intellectual property, technology, user growth or future market potential without having substantial current revenue or tangible assets. Consequently, valuation often involves assumptions about future performance. The legal concern is not merely the numerical value but whether the valuation process is adequately documented and whether the rights attached to the investment are understood by existing and incoming shareholders.

Future funding rounds can also dilute earlier shareholders. Anti-dilution provisions, preemptive rights and rights relating to new issuances are therefore common areas of negotiation. These provisions must be drafted consistently with the Companies Act and applicable securities and foreign exchange rules.

VI. Critical Discussion

The Indian venture capital framework has developed into a multi-layered system that addresses the different legal aspects of investment. The SEBI AIF framework regulates fund structures, company law governs the startup's issuance and governance, FEMA applies where foreign investment is involved, and tax and insolvency laws influence the economic consequences of

investment and exit. The framework therefore provides several safeguards, but the interaction of these regimes can also increase legal complexity.

A major concern is regulatory compliance at different stages of the same transaction. A fund may satisfy SEBI requirements while the portfolio company's securities issue still requires compliance with the Companies Act, and a foreign investor may additionally have FEMA obligations. The result is that transaction counsel must examine the investment as a connected legal structure rather than as a single document or approval.

A second issue is the bargaining imbalance that can arise in early-stage financing. Startups seeking urgent capital may accept complex contractual provisions without fully understanding their long-term effect. Provisions concerning liquidation preference, anti-dilution, veto rights, founder restrictions and exit rights can materially affect the economic position of founders and subsequent investors. Clear disclosure and professional legal advice are therefore important.

A third concern is the uncertainty surrounding valuation. Unlike mature companies, startups may have limited historical financial data. A valuation can therefore depend heavily on future expectations. Regulatory rules can address particular valuation consequences, but they cannot eliminate the commercial uncertainty inherent in startup investment.

A fourth concern is exit certainty. Venture capital is generally based on the expectation that the investment can ultimately be realised. If contractual exit mechanisms are difficult to implement because of company-law restrictions, foreign exchange rules, market conditions or lack of a suitable buyer, the investment may remain illiquid for longer than anticipated. Legal drafting should therefore consider realistic exit routes at the time of investment rather than treating exit as a purely future issue.

Recent regulatory developments demonstrate that the framework is adapting to the changing startup ecosystem. The removal of the angel-tax provision and continuing amendments to the AIF and foreign venture capital regulatory frameworks indicate movement towards reducing specific barriers while retaining regulatory oversight. However, reform should be accompanied by clear guidance so that legal uncertainty is not replaced by frequent changes that increase compliance costs.

VII. Suggestions and Areas for Reform

- Regulatory coordination should be improved so that companies, investors and advisers can identify all applicable requirements at an early stage.

- Regulatory guidance for startup fundraising should be consolidated in accessible form, particularly for private companies and first-time founders.
- Standardized explanatory guidance on commonly negotiated investment provisions could reduce misunderstanding without preventing parties from negotiating commercially appropriate terms.
- Compliance procedures for foreign venture capital investment should remain predictable, with clear timelines for reporting and regulatory responses.
- The legal framework should continue to balance investor protection with sufficient flexibility for startups to raise successive funding rounds.
- Greater attention should be given to practical exit mechanisms so that contractual rights are capable of being implemented within company law, securities law and foreign exchange rules.
- Startup founders and investors should undertake legal due diligence and obtain professional advice before finalizing term sheets and definitive investment documents.

VIII. Conclusion

Venture capital plays a vital role in providing finance to innovative and high-growth businesses in India. It gives capital at stages where normal debt may be unsuitable and also bring strategic knowledge, industry connections and governance support. However, the legal relationship between a venture capital investor and a startup is complex because it combines investment, corporate governance, contractual rights, regulatory compliance and exit considerations.

India has developed substantial framework for regulating these transactions. Like SEBI's Alternative Investment Fund regime provides a regulatory foundation for professionally managed venture capital funds, whereas the Companies Act, 2013 governs important aspects required for corporate fundraising and governance. FEMA and related RBI rules also become relevant when foreign capital is involved, similarly tax and insolvency laws also influence the broader investment lifecycle. Recent reforms, including the removal of section 56(2)(viib) from 1 April 2025 and continuing amendments to the AIF and FVCI frameworks, show that the regulatory environment is experiencing a dynamic change.

The foremost challenge is therefore not the absence of regulation but the need to make the existing framework transparent, coordinated and predictable. Effective regulation should protect investors and founders without creating unnecessary hurdles to legitimate capital

formation. A balanced framework which is supported by clear documentation, transparent valuation, reasonable governance rights and workable exit mechanisms, would strengthen the legal environment for venture capital while supporting the continued development of India's startup ecosystem.

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