



CROSS-BORDER INVESTMENT IN INDIAN START-UPS – METHODS & LEGAL FRAMEWORK

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ABSTRACT

When it comes to cross-border investments there are complicated Foreign Exchange laws in India which needs to be complied to avoid contravention and unwelcomed investigations by different government authorities. This paper aims to simplify and bring together in one paper all the rules and regulations which has to be abided with respect to the Foreign Direct Investment in Indian Startups as per the Consolidated Foreign Direct Investment Policy 2020, read with the Foreign Exchange Management Act, 1999 and subordinate legislations there under.

Keywords: *Cross-border investment, Foreign Direct Investment, Startups, Foreign Exchange Management Act, Compliance*

INTRODUCTION

India is a developing country with immense potential in the human resource which leads to abundance of innovative ideas and creative outputs. The Indian economy from past few

years is witnessing an exponential growth in the start-up ecosystem. India now has become the new hub of innovation and growth which makes it the most lucrative place for cross-border investments because the foreign investors aim to multiply their investment by investing in a country which has high growth prospects.

With the increasing number of startups, there has been an increase in transactions related to funding the start-up companies. Transactions such as Venture Capital, Private Equity has increased a lot. Along with these, cross-border investments have also increased.

When it comes to cross-border investments there are complicated Foreign Exchange laws in India which needs to be abided to avoid contravention and unwelcomed investigations by different authorities. This paper aims to simplify and bring together in one paper all the rules and regulations which has to be taken into consideration and abided with respect to the Foreign Direct Investment in Indian Start-up as per the Consolidated Foreign Direct Investment Policy 2020¹(herein after referred as '**the Policy**'), and different rules and regulations under the Foreign Exchange Management Act, 1999²(herein referred to as '**the Act**'/'**FEMA, 1999**').

WHAT IS CROSS-BORDER INVESTMENT?

Cross-border investment in simple terms means any investment or funding made by an Indian Company or any foreign entity or investment or funding made in an Indian

¹ Department for Promotion of Industry and Internal Trade, Ministry of Commerce, Government of India, Consolidated FDI Policy

² Foreign Exchange Management Act, 1999



company by any company which is incorporated outside India. This can be done through various ways like buying the securities or by way of mergers and acquisitions or by incorporating a new company etc.

Cross border investments are of two types, namely: -

1. **Inward Investment-** In this kind of investment, there is inflow of money or funds in India. i.e Foreigners or foreign company/entities/ persons are investing in Indian companies/ entities. Foreign Direct Investment (FDI) & Foreign Portfolio Investment (FPI) are examples of inward investments.
2. **Outward Investment-** In this kind of investment, the money or funds flows out of the Indian economy and is invested in companies incorporated outside India/ foreign entities. Overseas Direct Investment (ODI) is an example of Outward investment.

This article mainly focuses on the direct investments made in Indian start-ups and to understand the methods and legal framework, it is important to understand which parent law governs the cross-border transactions in India and the structure of the legislation, the authorities involved and the penal provisions in case of contravention/ non-compliance.

FDI IN INDIA AND ITS GOVERNANCE STRUCTURE

All the transaction with respect to Foreign Exchange in India are governed under the

FEMA, 1999 and such subordinate legislations made under the Act. As per section 46³ of the aforesaid Act, the Ministry of Finance (MoF) is empowered to issue rules and as per Section 47⁴ of the same, the Reserve Bank of India (RBI) is empowered to issue regulations regarding foreign exchange in India. The transactions are also governed by the Master Circulars issued by the Reserve Bank of India from time to time. RBI administers the Act and Directorate of Enforcement is the authority for enforcement under the Act.

The Policy is issued by the Department for Promotion of Industry and Internal Trade (DPIIT).

According to Schedule 1 of the Foreign Exchange Management (Transfer or Issue of Security by a Person Resident Outside India) Regulations, 2000⁵, FDI refers to any investment made in the capital of an Indian company by a Non-Resident Entity or a Person Resident Outside India. As a result of FDI, there is an alteration in the assets and liabilities of Indian companies, hence such transactions are capital account transactions. Penalties for violation or non-compliance of the Policy/ orders/ rules/ regulations of any of the authority are covered under the provisions specified in the Act.

As per section 13 (1) the penalty for contravention is as follows-

“If any person contravenes any provision of this Act, or contravenes any rule, regulation, notification, direction or order issued in exercise of the powers under this Act, or contravenes any condition subject to which

³ Foreign Exchange Management Act, 1999, S. 46

⁴ Foreign Exchange Management Act, 1999, S. 47

⁵ Foreign Exchange Management (Transfer or Issue of Security by a Person Resident Outside India) Regulations, 2000, Schedule I



an authorisation is issued by the Reserve Bank, he shall, upon adjudication, be liable to a penalty up to thrice the sum involved in such contravention where such amount is quantifiable, or up to two lakh rupees where the amount is not quantifiable, and where such contravention is a continuing one, further penalty which may extend to five thousand rupees for every day after the first day during which the contravention continues.”⁶

As per the Policy, there are possibly two routes through which Indian companies can receive FDI, them being - (a) Automatic route and (b) Government Route.

Under the Approval Route, the Indian companies can receive FDI in all activities/sectors as enlisted under the policy without prior permission of the government (MoF) and RBI.

For, FDI activities or sectors that are not enlisted under the automatic route, required permissions have to be taken for foreign investment under the Government route and it is completely on the discretion of the respective Authority/ Department to allow such foreign investment.

FDI IN INDIAN START-UPS

The legal framework pertaining to the main topic of the article is as per the Policy framed and issued by the DPIIT, which came into effect from October 15th, 2020.

A company is recognized as a ‘start-up company’ as per the notification issued from DPIIT, and they are:-

- ❖ The period of existence and operation of the company has not exceeded from 10 years from the date of incorporation;
 - ❖ The business is officially recognized as a Limited Liability Partnership (LLP) or a registered partnership under the Limited Liability Partnership Act, 2008⁷ and the Partnership Act, 1932⁸ respectively, or a private company under the Companies Act, 2013⁹ or 1956¹⁰.
 - ❖ The annual turnover in any financial year since incorporation should not have exceeded Rs. 100 Crore.
 - ❖ Entity should not have been formed out of reconstruction or splitting up of two companies, it should be an original entity.
 - ❖ The entity should work towards development and/or have a scalable business idea. Under the FDI Policy, the start-ups can raise funds by issuing: -
 - ❖ To Foreign Venture Capital Investors (FVCI) registered with the Securities Exchange Board of India (SEBI) in accordance with FEMA Regulations, either by issuing equity, equity-linked securities, or debt instruments; or
 - ❖ By issuing convertible notes to people who are residing outside India are subject to conditions discussed later in the article.
- Let us understand each of the method in detail.

⁶ Foreign Exchange Management Act, 1999, S. 13(1)

⁷ Limited Liability Partnership Act, 2008

⁸ Partnership Act, 1932

⁹ Companies Act, 2013

¹⁰ Companies Act, 1956



FDI IN EXCHANGE OF EQUITY OR DEBT INSTRUMENTS THROUGH FVCI

Start-ups can raise funds in exchange of equity shares or such equity linked instruments or debt instruments to registered FVCI.

FVCI has been defined under the SEBI (FVCI) Regulation 2000 as “foreign venture capital investor means an investor incorporated and established outside India, is registered under these Regulations and proposes to make investment in accordance with these Regulations”¹¹

The only compliance under this method is that Schedule VII of the Foreign Exchange Management (Non- Debt Instruments) Rules, 2009¹² has to be followed.

Schedule VII of the Foreign Exchange Management (Non- Debt Instruments) Rules, 2009¹³ read along with Rule 16 of the Rules deals with the rules which has to be followed by FVCI while investing.

Para 5 of the Schedule enlists the sectors in which the Foreign Venture Capital Investments can be made. But the given list does not apply to start-ups. FVCI can invest in a start-up irrespective of the sector in which the start-up belongs, pursuant to Para 1, discussed next.

“(5) List of sectors in which a Foreign Venture Capital Investor is allowed to invest is as follows:- (a) biotechnology;

(b) IT related to hardware and software development;
 (c) nanotechnology;
 (d) seed research and development;
 (e) research and development of new chemical entities in pharmaceutical sector.
 (f) dairy industry;
 (g) poultry industry;
 (h) production of bio-fuels;
 (i) hotel-cum-convention centres with seating capacity of more than three thousand;
 (j) Infrastructure sector. The term ‘Infrastructure Sector’ has the same meaning as given in the Harmonised Master List of Infrastructure sub-sectors approved by Government of India vide notification F. No. 13/06/2000- INF, dated the March 27, 2012 as amended or updated.”¹⁴

As per Para 1 of the Schedule a FVCI can purchase –

“(iii) equity or equity linked instrument or debt instrument issued by an Indian ‘start-up’ irrespective of the sector in which the start-up is engaged.”¹⁵

The proviso to Para 1 states that although investing is allowed, the route of FDI, sectorial cap on investment and other rules shall be complied.

As per Para 2 of the Schedule, the FVCI can purchase the above listed security or instruments directly from the issuer or from any other person holding such security or instrument.

¹¹ SEBI (Foreign Venture Capital Investors) Regulations 2000, Reg 2(g)

¹² Foreign Exchange Management (Non- Debt Instruments) Rules, 2009, Schedule VII

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¹⁴ Foreign Exchange Management (Non- Debt Instruments) Rules, 2019, Schedule VII, Para 5

¹⁵ Foreign Exchange Management (Non- Debt Instruments) Rules, 2019, Schedule VII, Para 1



As per Para 3 of the Schedule, FVCI can acquire or sell the securities or instruments to any person resident of India or Person Resident outside India any security or instrument which as per Para 1, the FVCI is eligible to invest in at any price determined by the buyer and seller mutually.

Para 4 states that mode of payment shall be specified by the RBI.

RBI issued Foreign Exchange Management (Mode of Payment and Reporting of Non-Debt Instruments) Regulations, 2019¹⁶ to specify the mode of payment.

As per Regulation 3.1.VII, Schedule VII Para (A) of Foreign Exchange Management (Mode of Payment and Reporting of Non-Debt Instruments) Regulations, 2019, “(1) *The amount of consideration shall be paid as inward remittance from abroad through banking channels or out of funds held in a foreign currency account and/ or a Special Non-Resident Rupee (SNRR) account maintained in accordance with the Foreign Exchange Management (Deposit) Regulations, 2016.*”¹⁷

Regulation 4¹⁸ of the Foreign Exchange Management (Mode of Payment and Reporting of Non-Debt Instruments) Regulations, 2019 enlists the reporting requirements pursuant to the above transaction.

According to Regulation 4(1)¹⁹, an Indian firm must report Form Foreign Currency Gross- Provisional Return (FC-GPR) within 30 days on the day the equity instrument was issued to the person who resides outside of India in exchange for FDI.

As per Regulation 4(2)²⁰, a company needs to submit Annual Return on Foreign Liabilities and Assets (FLA) before July 15th of each year.

As per Regulation 4(3) “(a) *Form FCTRS shall be filed for transfer of equity instrument in accordance with the rules, between:*

*a person resident outside India holding equity instruments in an Indian company on a repatriable basis and person resident outside India holding equity instruments on a non-repatriable basis; and
a person resident outside India holding equity instruments in an Indian company on a repatriable basis and a person resident in India,*”²¹

¹⁶ Foreign Exchange Management (Mode of Payment and Reporting of Non-Debt Instruments) Regulations, 2019

¹⁷ Foreign Exchange Management (Mode of Payment and Reporting of Non-Debt Instruments) Regulations, 2019, Schedule VII, Regulation 3.1.VII, Para A

¹⁸ Foreign Exchange Management (Mode of Payment and Reporting of Non-Debt Instruments) Regulations, 2019, Regulation 4

¹⁹ Foreign Exchange Management (Mode of Payment and Reporting of Non-Debt Instruments) Regulations, 2019, Regulation 4(1)

²⁰ Foreign Exchange Management (Mode of Payment and Reporting of Non-Debt Instruments) Regulations, 2019, Regulation 4(2)

²¹ Foreign Exchange Management (Mode of Payment and Reporting of Non-Debt Instruments) Regulations, 2019, Regulation 4 (3)



As per Regulation 5²², for any such delay in reporting, the company shall be held liable for payment of late submission fee.

FDI BY ISSUING CONVERTIBLE NOTES

As per the Policy 2020, under specific restrictions, start-ups are permitted to offer convertible notes to Persons Resident Outside of India.

Convertible notes are a type of financial instrument that are issued by a start-up company, after five years from such time of issuance and according to the terms and circumstances set forth in the instrument, may be repaid at the holder's discretion or converted into equity shares of the issuer company.

The conditions for issuing convertible notes are as follows: -

- i) *“A person resident outside India (other than an individual who is citizen of Pakistan or Bangladesh or an entity which is registered/incorporated in Pakistan or Bangladesh), may purchase convertible notes issued by an Indian start-up company for an amount of twenty-five lakh rupees or more in a single tranche”*²³
- ii) A start-up business that engages in any activity that calls for government clearance

for foreign investment may only issue convertible notes with government approval. Explanation to this clause states that *“For the purpose of this regulation, the issue of shares against such convertible notes shall have to be in accordance with the Schedule I of the Foreign Exchange Management (Non-Debt Instruments) Rules, 2019.”*²⁴

Schedule I states the different ways in which FDI can be brought in India and table attached to this schedule provides the sectoral cap and the route under which FDI can be infused in the various sectors of the economy.

- iii) As per clause iii, *“A startup company issuing convertible notes to a person resident outside India shall receive the amount of consideration by inward remittance through banking channels or by debit to the NRE / FCNR (B) / Escrow account maintained by the person concerned in accordance with the Foreign Exchange Management (Deposit) Regulations, 2016”*²⁵ where, NRE stands for Non-Residential External Account, FCNR (B) stands for Foreign Currency Non – Resident Bank. Proviso to this clause states that if Escrow Account is created for such transactions, it has to be closed immediately after the requirement the continuance of such account is not permissible after 6 months.

- iv) In accordance with clause iv, non-resident Indians (NRIs) may purchase convertible notes on a non-repatriation basis as long as Schedule IV²⁶ of the Foreign Exchange

²² Foreign Exchange Management (Mode of Payment and Reporting of Non- Debt Instruments) Regulations, 2019, Regulation 5

²³ Department for Promotion of Industry and Internal Trade, Ministry of Commerce, Government of India, Consolidated FDI Policy, Chapter 3: General Conditions of FDI, Para 3.2.6 (i), p 17

²⁴ Department for Promotion of Industry and Internal Trade, Ministry of Commerce, Government of India,

Consolidated FDI Policy, Chapter 3: General Conditions of FDI, Para 3.2.6 (i) Explanation, p 17

²⁵ Department for Promotion of Industry and Internal Trade, Ministry of Commerce, Government of India, Consolidated FDI Policy, Chapter 3: General Conditions of FDI, Para 3.2.6 (iii) Explanation, p 17

²⁶ Foreign Exchange Management (Non-Debt Instruments) Rules, 2009, Schedule IV



Management (Non-Debt Instruments) Rules, 2009 is followed.

Rule 12(2)²⁷ read with Schedule IV provides provisions related to investment by NRIs on non-repatriation basis.

As per Para A (1) (a) of the Schedule, “(a) A Non-resident Indian (NRI) or an Overseas Citizen of India (OCI), including a company, a trust and a partnership

firm incorporated outside India and owned and controlled by NRIs or OCIs, may purchase or contribute, as the case may be, on non-repatriation basis the following, namely:-

- (i) *a equity instrument issued by a company without any limit either on the stock exchange or outside it;*
- (ii) *units issued by an investment vehicle without any limit, either on the stock exchange or outside it;*
- (iii) *The capital of a Limited Liability Partnership without any limit;*
- (iv) **convertible notes issued by a startup company** *in accordance with these rules”²⁸*

A NRI, including a corporation, trust, or partnership that was incorporated outside of India and is owned and controlled by NRIs, is eligible to purchase convertible notes that startup companies are issuing on a non-repatriation basis.

- v) Convertible notes may be bought from or transferred to a Person Resident of India or Resident outside India by way of sale, as long

as the transfer complies with FEMA's applicable price regulations.

If the startup operates in a sector that needs government clearance, prior approval must be acquired before making any such purchases or transfers.

- vi) The entity issuing the notes must submit the required reports to the RBI. As per Foreign Exchange Management (Mode of Payment and Reporting of Non-Debt Instruments) Regulations, 2019's, Regulation 4(12)

“The Indian start-up company issuing Convertible Notes to a person resident outside India shall file Form CN within 30 days of such issue.

A person resident in India, who may be a transferor or transferee of Convertible Notes issued by an Indian start-up company shall report such transfers to or from a person resident outside India, as the case may be, in Form CN within 30 days of such transfer.”²⁹

The proviso to this regulation states that unless otherwise provided, all the reporting shall be made to Authorized Dealer Bank.

Regulation 5³⁰ of the Foreign Exchange Management (Mode of Payment and Reporting of Non-Debt Instruments) Regulations, 2019 also applies to this, which states that if there is any delay in filing any of the reports, it shall be accompanied by late submission fees.

²⁷ Foreign Exchange Management (Non-Debt Instruments) Rules, 2009, Rule 12(2)

²⁸ Para A (1)(a)

²⁹ Foreign Exchange Management (Mode of Payment and Reporting of Non-Debt Instruments) Regulations, 2019, Regulation 4 (12)

³⁰ Foreign Exchange Management (Mode of Payment and Reporting of Non-Debt Instruments) Regulations, 2019, Regulation 5



CONCLUSION

To conclude with, it can be stated that India is a developing country with immense potential to provide productive output to the world in every possible sphere and one of the major strengths of India as a country is its increased population. If this Human resource is utilized wisely then it can lead to innumerable number of creative outputs. Moreover, with the increase in population and considering the modern trends it can be seen that here has been a shift, as nowadays people are more interested in forming startups and enterprises instead of opting for a job in an existing company. But with such increase in startups and enterprises, it becomes necessary to be aware about the cross-border investments and foreign laws and regulations in order to ensure that such investments are righteous from the legal perspective. Such transactions are governed by Ministry of Finance (MoF) and Reserve Bank of India (RBI). This article also talks about the various aspects and criteria's that are to be fulfilled for a company to be called as a "start-up company". Moreover, this article also provides a brief overview about the Foreign Venture Capital Investors (FVCI'S) and the various such sectors in which they can make their investments.
