

India Update

Issue of Convertible Notes by Start-up Companies

In keeping with the government of India's "Start-up India" initiative, the Reserve Bank of India (**RBI**) has opened a new avenue for investments into start-ups in India. With effect from January 10, 2017, foreign investors are permitted to invest in Indian start-ups by subscribing to "convertible notes" issued by such companies. The notification issued by the RBI amends the Foreign Exchange Management (Transfer or issue of Security by a Person Resident outside India) Regulations 2000 (**FEMA Regulations**) – main regulations that govern transfer/ issue of instruments between residents and non-residents.

The notification defines a "convertible note" to be an instrument issued by a start-up company denoted as debt, which is convertible into equity of such start-up company within five years from the date of issue, upon occurrence of specified events as per the terms and conditions identified in the note.

Only a private company incorporated under the laws of India that complies with the requirements of a "start-up company" as set out by the Department of Industrial Policy and Promotion, Ministry of Commerce and Industry (**DIPP**) will be eligible to issue convertible notes under this route. A company is recognized as a "start-up" by the DIPP if (i) it has not completed a period of five years from the date of incorporation; and (ii) its annual turnover does not exceed ₹250 million in any financial year.

The following requirements must also be complied with in order to undertake such an investment:

- A single investment tranche must be a minimum amount of ₹2.5 million or more
- Consideration on issue of convertible notes must be received through normal banking channels
- Consideration may be received in an escrow account, provided the escrow account is closed as soon as the funds are utilized or within six months, whichever is earlier
- Acquisition/transfer of convertible notes must be carried out in accordance with the pricing guidelines prescribed by the RBI
- Government approval must be obtained if the start-up company is engaged in a sector where foreign investment is permitted only on obtaining government approval
- Acquisition/transfer of convertible notes issued by start-up companies engaged in a sector that requires government approval for foreign investment, may be carried out after obtaining prior government approval

- The start-up company must comply with the periodic reporting requirements prescribed by RBI for start-up companies

This move is likely to achieve the purpose of boosting the start-up environment in India, as young entrepreneurs will no longer be compelled to dilute their shareholding upfront in exchange for funds to develop their business. At the same time, these instruments will provide investors with the comfort of converting into equity on the occurrence of certain predetermined events.

The RBI's move to amend the FEMA Regulations is also in line with the Securities and Exchange Board of India's (**SEBI**) measures to allow angel investors to invest in start-up companies as provided for in the amended [SEBI \(Alternative Investment Funds\) Regulations, 2012](#).

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