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NEWSALERT

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BOOST TO FUNDING STARTUPS: THE ISSUE OF CONVERTIBLE NOTES TO FOREIGN INVESTORS

The Reserve Bank of India has amended the Foreign Exchange Management (Transfer or Issue of Security by a Person Resident outside India) Regulations, 2000 (the "**TISPRO Regulations**"), on January 10, 2017 (the "**TISPRO Amendment**"), to provide for the issuance of 'convertible notes' to foreign investors by start-up companies.[1]

1. BACKGROUND

The Government of India launched 'Startup India' a year ago by first releasing the 'Startup India: Action Plan' dated January 16, 2016 (the "**DIPP Notification**").[2] The objective of 'Startup India' was to build a strong eco-system for nurturing innovation and start-ups in the country that could drive sustainable economic growth and generate large-scale employment opportunities.

In furtherance thereto, the Government of India has over the year, introduced income tax exemptions and eased the environment and labour compliance process for recognized startups.[3] As on December 13, 2016, 522 (five hundred and twenty two) companies have been recognized as start-up companies.[4]

To further encourage investment into start-ups, the Reserve Bank of India introduced 'convertible notes' into the mix of permissible instruments issuable by a start-up company to a non-resident, pursuant to the TISPRO Amendment.

The Ministry of Corporate Affairs last year waived a major roadblock to the issuance of convertible notes by introducing an amendment to the Companies (Acceptance of Deposits) Amendment Rules, 2016, stating that convertible notes issued by a start-up company are excluded from the definition of 'deposits' under these rules.[5]

Pursuant to this TISPRO Amendment, start-up companies may issue convertible note to a foreign investor, subject to other conditions.

2. START-UP COMPANY

A 'start-up company' has been defined by the DIPP Notification as a company which: (a) is a private limited company; (b) has not completed 5 (five) years from its date of incorporation; (c) has annual turnover[6] during the previous financial year

[1] Notification No.FEMA.377/2016-RB, dated January 10, 2017, Reserve Bank of India, accessible at https://www.rbi.org.in/Scripts/NotificationUser.aspx?Id=10825&Mode=0

[2] Full text of the Action Plan may be accessed at: http://dipp.nic.in/English/Investor/startupIndia/StartupIndia_ActionPlan_16January2016.pdf (*Accessed on January 31, 2017*)

[3] Notification No. 45/2016, F. No. 173/103/2016-ITA-I dated June 14, 2016, Central Board of Direct Taxes, accessible at http://www.startupindia.gov.in/uploads/pdf/Notification%20related%20to%20Tax%20Exemption%20on%20Investments%20above%20Fair%20Market.pdf .

[4] Startup India – Status Report: http://www.startupindia.gov.in/uploads/other/status_report_on_startup_india.pdf (*Accessed on January 31, 2017*)

[5] Rule 2(vi), Companies (Acceptance of Deposits) Amendment Rules, 2016, Notification G.S.R. 639(E), dated June 29, 2016, Ministry of Corporate Affairs, accessible at https://www.mca.gov.in/Ministry/pdf/Rules_30062016.pdf

[6] "**Turnover**" has been defined in Section 2(91) of the Companies Act, 2013 as '*the aggregate value of the realization of amount made from the sale, supply or distribution of goods or on account of services rendered, or both, by the company during a financial year*'.

not exceeding INR 250 million; (d) is working towards 'innovation, development, deployment or commercialization of new projects, processes or services driven by technology or intellectual property'; and (e) has been recognized by the Department of Industrial Policy and Promotion.

3. THE TISPRO AMENDMENT

3.1 Definition of convertible notes

Under the TISPRO Amendment, a "**convertible note**" is defined as an instrument issued by a start-up company evidencing receipt of money initially as a debt, which is repayable at the option of the holder, or which is convertible into such number of equity shares of the start-up company, within a period of 5 (five) years from the date of issue of convertible note, upon the occurrence of specified events set out in the terms and conditions of the instrument.

3.2 Minimum investment

A convertible note may be issued by a start-up company for an amount equal to or higher than INR 2.5 million (approximately USD 36,705) in a single tranche.

3.3 Pricing of convertible notes

The TISPRO Amendment states that the issuance of shares against such convertible notes shall be made in accordance with Schedule I (the "**Foreign Direct Investment Scheme**") of the TISPRO Regulations.[7] Further, the acquisition or transfer of convertible notes must take place in accordance with the pricing guidelines under the TISPRO Regulations.

The Foreign Direct Investment Scheme provides that the valuation of shares issued to persons resident outside India must be done in accordance with any internationally accepted pricing methodology for valuation of shares on an arm's length basis, duly certified by a Chartered Accountant.

3.4 Other compliances

Indian companies may issue convertible notes only in compliance with the Foreign Direct Investment Scheme provided under the TISPRO Regulations. Therefore, a foreign investor may invest up to the prescribed sectoral cap without any additional permissions, if the business activity of the Indian company is classified under the automatic route.

If the sector of business activity of the start-up is under the government route, such foreign investment shall require the prior permission from the Foreign Investment Promotion Board (FIPB) of the Government of India. Start-up companies can issue convertible instruments at a general meeting of the members.[8]

A start-up company issuing convertible notes to a non-resident must receive the amount of consideration by inward remittance through banking channels or by debit to the NRE/FCNR (B) or Escrow account maintained by the concerned person, in accordance with the Foreign Exchange Management (Deposit) Regulations, 2016.

[7] Regulation 6D(2), TISPRO Amendment.

[8] Section 62(3) of the Companies Act, 2013 provides that a company need not follow the process of further issue of share capital, if a loan raised by a company is to convert into shares in the company. Provided that the terms of the loan which contains such option has at the time of issuance been approved by a special resolution passed by the company in a general meeting.

Further, an escrow account for the above purpose must be closed immediately after the requirements are completed, or within a period of 6 (six) months, whichever is earlier. However, continuance of such escrow account will not be permitted beyond a period of 6 (six) months in any case. Also, non-resident Indians ("**NRIs**") may acquire convertible notes on a non-repatriation basis in accordance with Schedule 4 of the TISPRO Regulations.

The Indian company must also comply with the reporting requirements for issuance and transfer of convertible notes, as applicable.

IndusLaw View:

Convertible notes should prove to be a popular form of investment for start-up companies, mainly because it is difficult to value these companies at their start-up stage, and the investor has the choice to put in debt, which could potentially be converted to equity at a latter stage.

This is particularly so for individuals or entities investing small amounts typical of such convertible notes since they do not have the resources to determine valuation of such start-ups.

For this reason, persons subscribing to convertible securities simply peg it to a discount to further rounds of investment where institutional investors come in who have the means and ability to determine the valuation of the company.

In other countries, convertible notes have been the norm for start-up companies to raise initial seed investment. In other economies, the conversion of such convertible notes is done at a significant discount to the market price determined at the next major investment round received by the company.

However in India, the TISPRO Regulations mandate that rate of conversion must be determined upfront, and the rate at which the convertible note converts shall not be at a price less than the *fair market value* determined at the time of issuance of such convertible note.

This would severely impact the utility of such convertible notes. It would be helpful if valuation norms are done away with for convertible notes or otherwise, express provisions allowing for valuation based on a discount to future valuation be permitted.

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