Exchange Control Provisions for Startups

Startup Series #7

Foreign Exchange Management Act (FEMA) was introduced to facilitate / regulate external payments/ receipts and cross border transactions. FEMA outlines the formalities and procedures for the dealings of all foreign exchange transactions in India. Some specific provisions have been introduced for startups to encourage them to get foreign investments and to enter and compete in global market.

*In continuation to our **'Startup Series',** let us look at the various foreign exchange control provisions for start-ups in **#7** of the series*

M2K Advisors

Foreign Direct Investment (FDI) in General (1/3)

- FDI means an investment by a person resident outside India (PROI) [1] in an unlisted Indian company and/or in 10% or more of the post issue paid up equity capital on a fully diluted basis of a listed Indian company, through equity instruments[2] .
- Investments by PROI in Indian company are subject to entry route conditions, sectoral caps, investment limits, pricing guidelines, etc. Predominant sectors are under automatic route.
- Equity instruments to **be issued within 60 days** from date of receipt of funds in case of allotment. If not, amount to be **refunded within 15 days** from the expiry of 60 days.
- Indian company can also issue ESOP/sweat equity shares to **employees/directors who are PROI.**
- PROI holding equity instruments in Indian company can transfer to resident Indian by way of **sale or gift.** In case of sale, pricing guidelines shall apply.
- Issue of equity instruments shall be reported through **Form FC GPR**, while transfer of the same through **Form FC TRS**. And a yearly compliance in **Form FLA**. The onus of all the reporting is on resident.

***1** Other than an individual who is citizen of Pakistan / Bangladesh or an entity which is registered or incorporated in Pakistan / Bangladesh.* ***2** Equity instruments means equity shares (including partly paid-up shares and share warrants), fully & mandatorily convertible debentures, fully & mandatorily preference shares and share warrants issued by an Indian company.*

FDI - Additional route for Startups (2/3)

Convertible note is an instrument issued by a start-up company acknowledging receipt of money initially as debt, repayable at the option of the holder, or which is convertible into such number of equity shares of that company, **within a period not exceeding five years from the date of issue of the convertible note**, upon occurrence of specified events as per other terms and conditions agreed and indicated in the instrument.

- Convertible Notes can be issued by an Indian startup company (refer definition in #1) for **an amount of Rs. 25 Lakh or more in a single tranche** to PROI under automatic route (provided the said sector does not require Govt approval).
- The Convertible Note should be repaid / converted to equity shares within a **period not exceeding five years** from the date of issue
- A startup company issuing Convertible Notes to a PROI shall file Form CN **within 30 days of issue.**
- Sale of Convertible Notes between a resident and PROI **shall be reported** by the transferor/transferee, resident in India, in Form CN within 30 days.
- Issue of equity shares against such convertible notes shall be in compliance with the entry route, sectoral caps, pricing guidelines and other conditions

FDI - Additional route for Startups (3/3)

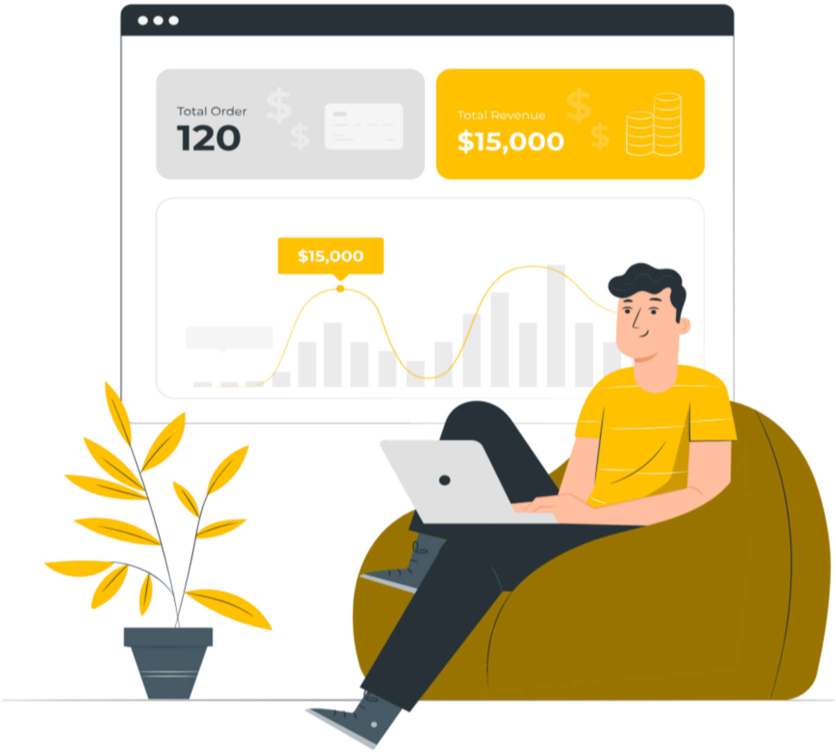
M2K Advisors

Foreign Venture Capital Investor (FVCI)

Foreign Venture Capital Investor is an investor incorporated & established outside India and registered with the SEBI.

Generally, FVCI may purchase securities, issued by an Indian company engaged only in **specified sectors**** and whose securities are not listed on a recognized stock exchange at the time of issue of the said securities.

However, in case of Startups, FVCI may invest (either in equity or equity linked instrument or debt **instrument) irrespective of the sector** in which it is engaged. However, if the investment is in equity instruments, sectoral caps, pricing guidelines, etc. shall apply.



** *Specified sectors are* biotechnology; IT related to hardware and software development; nanotechnology; seed research and development; research and development of new chemical entities in pharmaceutical sector. dairy industry; poultry industry; production of bio-fuels; hotel-cum-convention centres (with seating capacity of more than three thousand), Infrastructure sector.

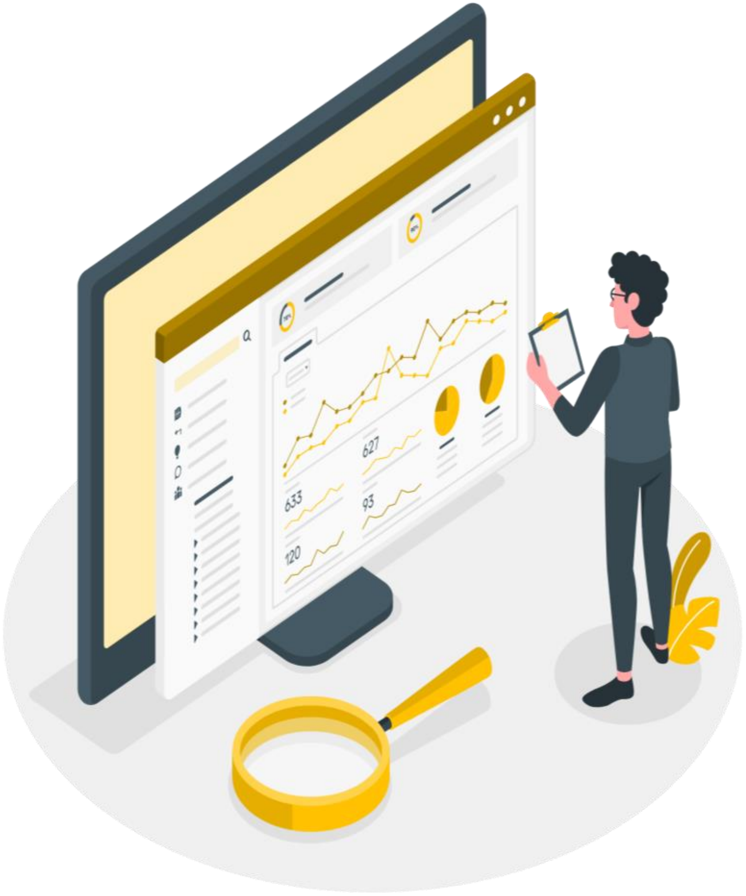
Overseas Direct Investment (ODI)

- Indian party may invest/ undertake financial commitment (FC) in overseas entity up to **400 percent** of its net worth (subject to USD 1 billion per FY). **Corporate Guarantee to fall within this limit.**
- Share certificates to be received **within 6 months** from date of remittance/ capitalization
- Indian Party may extend loan to overseas JV/ WOS in which it **has equity participation**. Loan or FC without equity participation considered **under Approval route**
- All dues receivable from overseas JV/ WOS, **to be repatriated to India** within 60 days of its falling due or time limit prescribed under FEMA regulations. Indian Party can **capitalize payments due** from foreign entity. Capitalization beyond prescribed period of realization requires prior RBI approval
- Swap of shares-valuation to be done by Category I Merchant Banker registered with SEBI or Investment Banker/ Merchant Banker outside India registered with regulatory authority in host country. **DPIIT approval required for Approval Route**
- In case of divestment, Indian Party to report within 30 days and repatriate sales proceeds of investment not later than 90 days.
- Form ODI Part I and III needs to be filed at the time of investment and disinvestment, respectively. **Form FLA** to be filed by **July 15 and Form APR** by **December 31.** Any change in Indian party or investment in step down subsidiary needs to be intimated to Authorized Dealer Banker in specified form.
- The above provisions shall apply to start ups also who are investing in overseas entity.

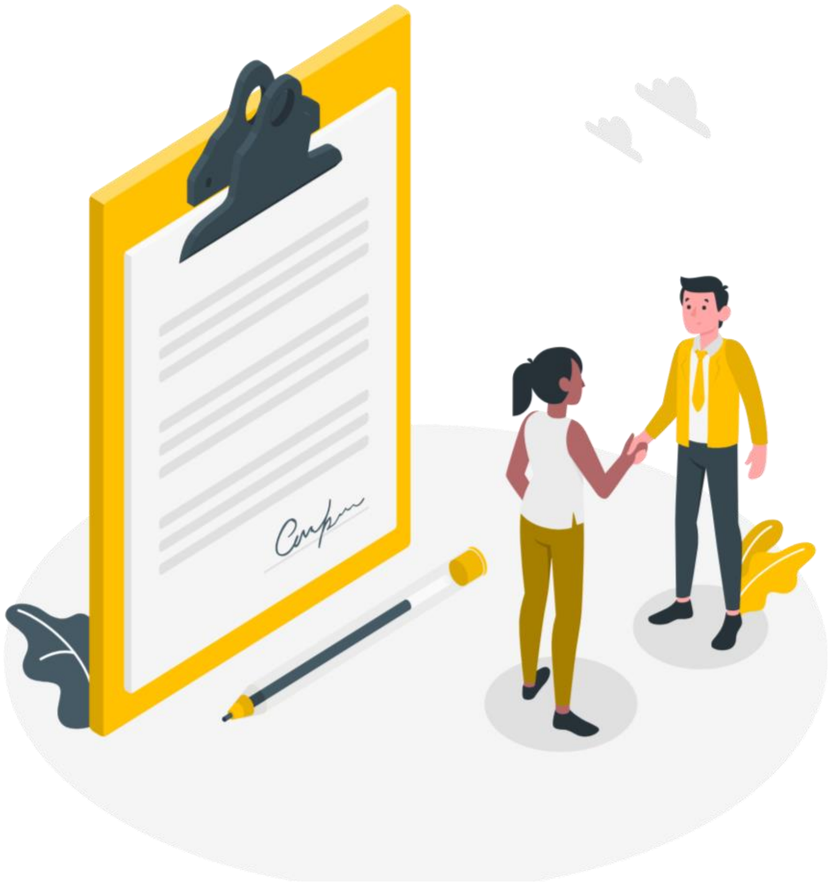
External Commercial Borrowings (ECB) – In General

ECB Regulations ***govern loans/ borrowings by eligible Indian entities*** from outside India. Automatic route covers bank loans, debt securities such as bonds, non-convertible/ optionally convertible preference shares or debentures, foreign currency convertible bonds, RDBS, finance lease, etc., subject to following conditions:

- **Eligible borrower:** All entities eligible to receive FDI can raise ECB.
- **Recognized Lenders:** Lender should be resident of FATF or IOSCO compliant country.
- **Minimum average maturity (MAMP):** ECB shall generally have MAMP of 3 years but in case of specified categories - MAMP ranges from 1 year to 10 year based on end use of ECB
- **All-in-cost ceiling:** Benchmark rate plus 450 bps spread. It includes rate of interest, other fees, charges, guarantee fees, export credit agency charges, whether paid in foreign currency or INR but will not include commitment fees and withholding tax payable in INR.
- **Loan Registration Number (LRN):** Borrowers required to submit duly certified Form ECB to designated AD banker to obtain LRN.
- **End use:** ECB proceeds cannot be utilized for activities specified in negative list.
- **Reporting:** Borrowers to report actual ECB transactions through Form ECB 2 return through AD Bank on monthly basis.



ECB – Relaxation for Startups



AD Category-I banks are permitted to allow Startups (refer definition in #1) to raise ECB under the automatic route.

Generally, the Minimum average maturity **(MAMP)** for working capital purposes is **5 years** (in case ECB is from foreign equity holder) and **10 years** (in case of others). However, for startups the MAMP period is 3 years.

The borrowing can be in form of loans or non-convertible, optionally convertible or partially convertible preference shares.

The borrowing per startup is limited to **USD 3 million** or equivalent per financial year.

The end uses of the borrowed money shall be for any expenditure in connection with the business of the borrower.

Conversion into equity **is freely permitted** subject to Regulations applicable for **foreign investment** in Startups.

All in cost shall be **mutually agreed** between borrower and the lender.

Deposits and Accounts

M2K Advisors

- **A** An Indian startup (refer definition in #1) can open Exchange Earner's Foreign Currency (EEFC) Account with an AD Banker in India.
- **B** Apart from general credits permitted to EEFC account, an Indian startup can **receive payments in foreign currency** arising out of sales/ export made by it or its overseas subsidiaries.
- **C** Indian startup, having an overseas subsidiary, may open a foreign currency account with a bank outside India for the **purpose of crediting** to the account the foreign exchange earnings out of exports/ sales made by the said startup or its overseas subsidiary.
- **D** The balances held in such accounts, to the extent they represent exports from India, **shall be repatriated to India**, within the due date specified for repatriation.

Typical contraventions by Indian entities/ start ups

Contravention is a breach of the provisions of the FEMA and rules/ regulations/notification/ orders/ directions/ circulars issued there under. *Following are a few common contraventions under FDI, ODI, and ECB:*

FDI	ODI	ECB
Delay in issue of shares / refund of share application money.	Delay / non submission of APR.	Delay / non submission of ECB 2
Delay / non submission of FCTRS, FCGPR and FLA	Delay in obtaining share certificate.	Not obtaining LRN
Issue of non permissible / ineligible instruments	Non permissible method of funding or non permissible sector.	Utilizing ECB proceeds for activities, not permissible under the regulations.

Penal Provisions

Contravention of any provision of FEMA or any rules, regulations, notifications, directions or order issued in exercise of powers thereunder may be penalized by Adjudicating Authority.

Quantifiable

Up to 3 times the sum involved in contravention where such amount is quantifiable

Non-Quantifiable

Up to INR 2 lakhs where the sum involved is not quantifiable

Continuous

For continuing contravention penalty may extend to INR 5,000 for every day after first day during which contravention continues

Additionally, Adjudicating Authority may direct that any currency, security or any other money or property in respect of which contravention has taken place to be confiscated by the Central Government. It may direct persons committing contraventions to bring back foreign holdings into India or to retain outside India in accordance with Regulations/ Directions

Stay tuned for more updates on Startups!

M2K Advisors

In case you have missed the previous alerts, click on the hyperlinks to refer the same.

- #1 Startup recognition
- #2 Tax holiday benefit
- #3 Angel Tax Exemption
- #4 Taxability of ESOPs
- #5 Carry forward & set off of losses by startups
- #6 Capital gains exemption on investment in startups
- #7 **Exchange control provisions**
- #8 **Labor law relaxations**
- #9 **Startup India Seed Fund**
- #10 **Other regulatory provisions / benefits**

THANK YOU

M2K Advisors

Chennai - India
M2K Advisors LLP
1st Floor, No. 62, 3rd street,
Abhiramapuram, Alwarpet,
Chennai - 600018
Tamil Nadu

Hyderabad - India
M2K Advisors LLP
Manjeera Trinity Corporate
JNTU Road, Plot No S2 ,
Telangana- 500072
Hyderabad

Singapore
M2K Advisors Pte Ltd
The Octagon,
105 Cecil Street, #07-02
Singapore 069534

USA
M2K Sai Advisors Inc
1 AUER CT,
2nd Floor, East
Brunswick
New Jersey - 08816

For any queries, reach us at:
Mukesh@m2k.co.in; Swetha@m2k.co.in; +9144 4263 9000