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ISSUE OF CONVERTIBLE NOTE BY STARTUP COMPANIES

Introduction

The Reserve Bank of India ("**RBI**"), *vide* its recent notification amended the Foreign Exchange Management (Transfer or Issue of Security by a Person Resident Outside India) Regulations, 2000 ("**Principal Regulations**") permitting issuance of '*Convertible Note'* ("**New Instrument**") by start-up companies to a person resident outside India (i.e. other than individuals who are citizens of Pakistan or Bangladesh or an entity which is registered/incorporated in Pakistan or Bangladesh) ("**Permitted Investors**").

Amendments to the Principal Regulations

The Principal Regulations are amended to provide the definition of '*Convertible Note*' as follows:

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

Further, a new Regulation is introduced setting out provisions relating to issuance of the New Instrument by startup companies, which provides that:

- The Permitted Investors are may purchase New Instrument issued by startup companies for a minimum amount of INR 25,00,000 or more. The term '*startup company*' means a private company incorporated under the Companies Act, 2013 or Companies Act, 1956 and recognised as such in accordance with notification dated February 17, 2016 issued by the Department of Industrial Policy and Promotion, Ministry of Commerce and Industry.

- Prior government approval is required in cases where the issuing startup company is engaged in a sector where foreign investment requires prior government approval in accordance with Schedule 1 of the Principal Regulations.

- The investee startup company issuing convertible notes to the Permitted Investors is required to receive the investment amount by way of inward remittance through banking channels or by debit to the NRE / FCNR (B) / escrow account maintained in accordance with the Foreign Exchange Management (Deposit) Regulations, 2016. If the inward

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remittance is through escrow account then, the said escrow account is required to be closed immediately after the subscription and issuance of the convertible note is completed or 6 months, whichever is earlier. Provided further that no such escrow account shall be permitted to remain open after 6 months (of opening the concerned escrow account) under any circumstances.

- Non- Resident Indians are allowed to acquire convertible notes on non-repatriation basis in accordance with the Schedule 4 of the Principal Regulations (which sets out the terms on which investments can be made by Non Resident Indians).

- A Permitted Investor is permitted to acquire or transfer, by way of sale, convertible notes, from or to, a person resident in India or another Permitted Investor provided the transfer takes place in accordance with the pricing guidelines as prescribed by RBI. Prior government approval would be required to be obtained for such transfers in case the startup company is engaged in a sector which requires prior government approval.

- The startup company issuing the New Instrument shall be required to furnish reports as prescribed by the RBI.

Introduction of a new security is good step towards liberalisation of the foreign investment policies and a boost to start-up companies for accessing foreign investments. The notification appears to be silent regarding the compliance and reporting procedure to be followed for receipt of foreign investment against issuance and subscription of the New Instrument. It is unclear whether any amendment would be carried out in the External Commercial Borrowing Policy in the future since a ‘*convertible note*’ as a security can remain to be debt until 5 years and not mandatorily be required to be converted into equity shares of the investee startup company unlike the other capital instruments permitted to be issued under the Principal Regulations.

Disclaimer

For further clarification, you may write to the Exchange Control Team comprising of (amongst others) Mr. Vaishakh Kapadia (Partner) at vkapadia@almtlegal.com and Ms. Shweta Tewari (Associate) at stewari@almtlegal.com.