
NON-RESIDENT INDIAN (NRI) VENTURE-DEBT INSTRUMENTS: FEMA COMPLIANCE AND CROWDFUNDING PLATFORMS

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ABSTRACT

In this research paper, the regulatory regime applying to Non-Resident Indian (NRI) investments in venture-debt instruments using equity-based crowdfunding platforms under India's Foreign Exchange Management Act, 1999 (FEMA) is scrutinized¹. Analysis aims at scrutinizing FEMA's categorization and permissibility of financial instruments such as convertible notes, compulsorily convertible debentures (CCDs), optionally convertible debentures (OCDs), and non-convertible debentures (NCDs). The article analyses compliance requirements for Indian startups and NRIs, analysing sectoral limits, minimum investment levels, and procedural reporting measures. It further discusses the nexus of FEMA with the Securities and Exchange Board of India (SEBI) regulations on crowdfunding, discussing regulatory shortcomings and proposing reforms to standardize these frameworks. Judicial rulings and enforcement tendencies detail doable hurdles in compliance. The article ends by providing particular suggestions directed at simplifying FEMA regulations for the purpose of promoting NRI investment in India's startup ecosystem.

¹ Foreign Exchange Management Act, 1999, No. 42, Acts of India 1999, § 3 (India).

Introduction

India's fast-evolving startup ecosystem increasingly relies on innovative funding schemes, between which venture-debt tools have received increasing attention. Non-Resident Indians (NRIs), considering their fiscal capability and investment interest in India's economy growth, form a big source of financing for such ventures. But their entry involves traversing intricate regulatory regimes under the purview of the Foreign Exchange Management Act, 1999 (FEMA). The regulatory challenge escalates when these investments are made through equity-based crowdfunding platforms, which remain poorly regulated by the Securities and Exchange Board of India (SEBI). The following paper seeks to undertake an in-depth analysis of FEMA's regulatory structure, assess acceptable financial instruments, identify compliance requirements, explain judicial precedents, and lay down regulatory reforms required.

FEMA Regulatory Structure

FEMA classifies cross-border transactions into two types: current account and capital account transactions. Current account transactions, including everyday business and individual transactions, are typically allowed unless expressly prohibited. Capital account transactions involving investments changing the cross-border liability and asset positions have to be specifically authorized under FEMA. FEMA then segregates these capital account transactions into Foreign Direct Investments (FDI) under the FEMA (Non-Debt Instruments) Rules, 2019, and External Commercial Borrowings (ECB) under the FEMA (Borrowing and Lending) Regulations, 2018. All these rules specify approved channels, eligibility conditions, sectoral ceilings, and procedural requirements for foreign investors, including NRIs.

Classification and Permissibility of Instruments in FEMA

1. Equity and Compulsorily Convertible Instruments

The fully convertible instruments, specifically compulsorily convertible preference shares (CCPS) and compulsorily convertible debentures (CCDs), are treated under FEMA as non-debt or equity instruments. These instruments are eligible for investment in automatic routes, subject to certain sectoral limits and procedural requirements. NRIs investing via these instruments have relatively easier compliance with reduced complexity, including simplified reporting and compliance with pricing guidelines.

2. Optionally Convertible and Non-Convertible Instruments

Optionally convertible debentures (OCDs) and non-convertible debentures (NCDs) qualify as debt instruments under FEMA. Investment in these instruments by NRIs on a repatriable basis comes under the ECB framework, imposing stringent conditions like minimum tenor requirements, certain end-use prohibition, all-in-cost limits, and lender eligibility standards. Such regulatory parameters tend to curtail the appeal of OCDs and NCDs towards startup financing because of the compliance complexity involved and large-scale administrative load.

3. Convertible Notes

In 2017, given the special financing needs of startups, the Reserve Bank of India (RBI) launched convertible notes by Notification FEMA 377/2016-RB. Convertible notes are debt instruments that can be converted into equity shares within ten years from date of issue. Convertible notes can be used for investment by NRIs either via a repatriable channel (FDI regime) or a non-repatriable channel (Schedule IV). Their ease of structure and reduced compliance requirements compared to conventional ECB products have made them preferred venture-debt instruments among NRIs and start-ups.

Compliance Requirements for NRIs and Startups

1. Investor Compliance Requirements

NRIs need to comply with FEMA guidelines as far as investment channels are concerned. Such investors have the option to go for repatriable investment from Non-Resident External (NRE) or Foreign Currency Non-Resident (FCNR) accounts or non-repatriable investment from Non-Resident Ordinary (NRO) accounts. Further compliance measures involve keeping minimum investment limits, like INR 25 lakhs per tranche for convertible notes and furnishing detailed Know Your Customer (KYC) documents, such as Foreign Inward Remittance Certificates (FIRCs).

2. Issuer Compliance Requirements

Startups that disburse venture-debt instruments to NRIs are required to adhere strictly to FEMA regulations. Compliance requires choosing allowable instruments according to FEMA categorization, reporting in a timely manner using authorized channels (e.g., Form CN in 30

days from date of issuance, Single Master Form filings for equity instruments), and fulfilling periodic reporting requirements. Firms should ensure compliance with sectoral limits and price guidelines, recordkeeping in a proper manner, and usage of proper banking channels to receive and document investments.

3. SEBI Regulations and Equity-Based Crowdfunding Platforms

Currently, India lacks comprehensive SEBI regulations governing equity-based crowdfunding platforms. SEBI's 2014 Consultation Paper proposed frameworks to restrict crowdfunding to accredited investors, enforce investor participation caps, and mandate platform registrations. However, these proposals have not yet been enacted, leaving crowdfunding activities regulated indirectly through private placements under the Companies Act, 2013, or through Alternative Investment Fund (AIF) mechanisms. Both options demand strict adherence to FEMA investment regulations, burdening platforms to guarantee proper compliance measures are adopted and implemented strictly.

Judicial Precedents and Trends in Enforcement

The *IDBI Trusteeship Services Ltd. v. Hubtown Ltd.* (2015) ruling of the Bombay High Court highlights judicial interpretation with respect to FEMA violation, where optionally convertible debentures designed to conceal debt as equity were held to be breaches of FEMA, making related guarantees unenforceable. The Enforcement Directorate's (ED) case against NDTV in 2018 further highlights strict regulatory scrutiny of foreign borrowings circumventing prescribed FEMA approvals. Additionally, RBI's compounding orders consistently illustrate regulatory vigilance in enforcing compliance with reporting requirements, even in cases involving minor lapses.

Regulatory Gaps and Recommendations for Reform

A number of regulatory lacunae currently hinder effective and lawful NRI investment in India's startup funding ecosystem. The most important issues are strict instrument categorization, time-consuming reporting requirements, and no clear crowdfunding regulation. Suggested reforms are:

1. Official enactment of thorough SEBI regulations of equity-based crowdfunding clearly consistent with FEMA rules.

2. Enlargement of allowed non-debt instruments under FEMA to include obviously regulated optionally convertible instruments.
3. Launching streamlined ECB rules (“ECB Lite”) in special offerings to startup borrowings below certain levels.
4. Simplifying and consolidating FEMA compliance reporting to minimize administrative hurdles on issuers and investors alike.
5. Clearly defining NRI non-repatriation channels for debt investments under Schedule IV to increase investment flexibility and compliance certainty.

Conclusion

Compliance with FEMA for NRI investments in venture-debt products through equity-based crowdfunding platforms continues to be confusing owing to prevailing regulatory constraints. While convertible notes and compulsorily convertible instruments offer comparatively viable options, strict regulatory categorization, compliance difficulties, and a lack of detailed SEBI guidelines limit wider investor involvement. Adopting focused regulatory reforms that aim to harmonize FEMA and SEBI rules can abate significant compliance risks considerably, simplify procedural demands, and release huge cross-border venture capital, enabling increased NRI involvement in India’s fast-growing startup ecosystem.