

**INVESTMENT INSTRUMENTS UNDER INDIAN LAW: CHOOSING THE RIGHT STRUCTURE FOR
STARTUP FUNDRAISING**

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Raising capital is one of the most defining milestones for any startup. As founders navigate their early growth journey, the choice of corporate finance instruments becomes more than a matter of convenience, it determines ownership structure, compliance obligations, and long-term investor relationships. In simple terms, these instruments represent the legal form through which investors bring funds into a company. Broadly, such instruments fall into two categories: equity-based instruments, which reflect ownership and participation in profits (such as equity shares and compulsorily convertible preference shares or CCPS), and debt-based instruments, which embody a borrowing relationship with a fixed obligation to repay (non-convertible debentures and notes).

Choosing the right instrument is crucial for startups because each structure carries distinct implications for valuation, control, and compliance. An early-stage founder may prefer equity instruments to attract long-term investors and align incentives, while a later-stage company may explore convertible or debt-linked instruments to defer dilution or manage risk.

In India, the regulatory landscape governing these instruments is multi-layered. Further, the legal framework for such instruments differs based on the investor's residency status. Investments made by resident investors are primarily governed by the *Companies Act, 2013* and its accompanying rules. In contrast, investments by non-resident investors trigger additional compliance under the Foreign Exchange Management Act, 1999 (FEMA) and related regulations issued by the Reserve Bank of India (RBI). Specifically, equity-linked instruments are governed by the *Foreign Exchange Management (Non-Debt Instruments) Rules, 2019*, while debt or convertible instruments fall under the *Foreign Exchange Management (Borrowing and Lending) Regulations, 2018* and the RBI's External Commercial Borrowing (ECB) Framework.

Understanding this regulatory distinction is not just a legal necessity but a strategic choice that directly affects how startups raise, retain, and report capital.

Types of Corporate Finance Instruments for Startups

Startups in India today have access to a diverse set of instruments for raising capital, from conventional equity shares to hybrid securities like CCPS, CCDs, and convertible notes. Each carries distinct implications for valuation, control, investor protection, and compliance under Indian law.

1. Equity Shares

Equity shares constitute the fundamental ownership interest in a company. Holders participate in profits through dividends and exercise control through voting rights

proportionate to shareholding. Upon liquidation, they are entitled to residual assets only after creditors and preference shareholders are paid.

Characteristics:

Equity shares are non-convertible and carry the highest risk but also the potential for the highest return. They may be issued with differential voting rights under Section 43(a)(ii) read with Rule 4 of the Companies (Share Capital and Debentures) Rules, 2014. Equity holders usually have no liquidation preference, are last in line during winding-up, and benefit from corporate growth through appreciation in share value.

Use Cases:

Equity shares are typically used in founder capital, angel rounds, and later-stage equity raises where investors seek long-term ownership and governance participation. For domestic founders, equity is the cleanest structure; for non-resident investors, it ensures voting parity and dividend participation, subject to pricing and sectoral caps under the Foreign Exchange Management (Non-Debt Instruments) Rules, 2019.

Legal Framework:

- a. Under the Companies Act, 2013:
 - i. Equity shares are primarily governed by Sections 43, 47, and 53, which define share capital structure, voting rights, and issuance of shares at a premium or discount.
 - ii. The Companies (Share Capital and Debentures) Rules, 2014 prescribe conditions for issuance, including differential voting rights and procedural compliance.
- b. Under the Foreign Exchange Management (Non-Debt Instruments) Rules, 2019 (*for non-resident investors*):
 - i. Rule 2(v) and Schedule I classify equity shares as “equity instruments” eligible for foreign direct investment (FDI).
 - ii. Subject to sectoral caps, pricing norms, and reporting in Form FC-GPR (for issuance) and Form FC-TRS (for transfer) under the supervision of the Reserve Bank of India (RBI).

2. Compulsorily Convertible Preference Shares (CCPS)

CCPS are preference shares that must convert into equity after a fixed period or upon specified triggers (e.g., next funding round). They combine the liquidation priority of debt with the eventual ownership features of equity, offering a bridge between investor protection and long-term participation.

Characteristics:

- a. **Mandatory Conversion:** Conversion ratio, period, and conditions are fixed at issuance.

- b. **Preferential Treatment:** Receive priority dividends and liquidation preference under Section 43(b) of the Companies Act, 2013.
- c. **Investor Protection:** Frequently embed anti-dilution, tag-along, and board-observation rights.
- d. **Voting Rights:** Limited until conversion unless dividends remain unpaid for two years (Section 47(2) of the Companies Act, 2013).

Use Cases:

CCPS are the most common instrument in venture capital and private-equity rounds, allowing investors to enjoy economic preference and governance rights without being treated as creditors. Founders prefer CCPS to avoid debt exposure while keeping shareholding flexible until conversion.

Legal Framework:

- a. Under the Companies Act, 2013:
 - i. Governed by Sections 43(b) and 55, which define preference share capital and prescribe conditions for issue and redemption.
 - ii. The Companies (Share Capital and Debentures) Rules, 2014, particularly Rule 9, regulate the issue of preference shares, including terms of conversion, dividend rights, and tenure.
- b. Under the Foreign Exchange Management (Non-Debt Instruments) Rules, 2019 (*for non-resident investors*):
 - i. Rule 2(v)(ii) and Schedule I classify CCPS as “equity instruments” eligible for foreign direct investment (FDI), subject to sectoral caps, pricing norms, and reporting requirements under the Reserve Bank of India (RBI).

3. Optionally Convertible Preference Shares (OCPS)

OCPS are preference shares granting investors the right but not the obligation to convert into equity. They offer flexibility between fixed-return preference and potential equity participation, often aligning with investor risk appetite.

Characteristics:

- a. **Optional Conversion:** Conversion may be exercised by the company or the investor, providing optionality.
- b. **Dividend and Liquidation Preference:** Entitled to fixed dividend and priority repayment until conversion.
- c. **Hybrid Character:** Because conversion is not mandatory, OCPS are treated as debt-like under Indian exchange-control law.
- d. **Governance:** May include restrictive covenants or veto rights negotiated in shareholders’ agreements.

Use Cases:

Common in domestic or promoter-funded rounds, OCPS are suited for strategic or corporate investors seeking a fixed return but optional upside participation. They also work in joint ventures or convertible partnership deals where both parties want deferred valuation decisions.

Legal Framework:

- a. Under the Companies Act, 2013:
 - i. Governed by Sections 43(b) and 55, and Rule 9 of the Companies (Share Capital and Debentures) Rules, 2014, which regulate the issuance, conversion terms, dividend rights, and tenure of preference shares.
 - ii. Under Rule 2(1)(c)(ix) of the Companies (Acceptance of Deposits) Rules, 2014, Optionally Convertible Preference Shares (OCPS) are excluded from the definition of deposits when issued for a period not exceeding ten years and in accordance with prescribed conditions.
- b. Under the Foreign Exchange Management (Non-Debt Instruments) Rules, 2019:
 - i. OCPS are not treated as equity instruments; consequently, foreign investment in OCPS is regarded as debt and governed by the Foreign Exchange Management (Borrowing and Lending) Regulations, 2018, under the regulatory supervision of the Reserve Bank of India (RBI).

4. Compulsorily Convertible Debentures (CCDs)

CCDs are debentures issued under Section 71 of the Companies Act, 2013 that automatically convert into equity shares after a fixed period or trigger event. Although technically issued as debt, they function as deferred equity, combining the procedural ease of debt issuance with the regulatory recognition of equity.

Characteristics:

- a. **Mandatory Conversion:** CCDs must convert into equity shares after a specified period or upon defined triggers; repayment in cash is not permitted.
- b. **Predetermined Terms:** The conversion ratio, price, and timeline are fixed upfront at the time of issuance.
- c. **Nature of Security:** Though issued as debentures, CCDs are treated as equity instruments under law owing to their compulsory conversion.
- d. **Interest Structure:** CCDs generally carry a nominal or zero-coupon interest, aligning investor returns with future equity value.
- e. **Liquidation Position:** Holders rank as creditors until conversion and as shareholders thereafter.
- f. **Regulatory Classification:** Recognised as “equity instruments” under the Foreign Exchange Management (Non-Debt Instruments) Rules, 2019, making them eligible for foreign investment.

Use Cases:

CCDs are widely used in Series A to Series C funding rounds, particularly by foreign venture capital and private equity investors, to structure compliant cross-border investments. They allow startups to raise funds while deferring valuation and share issuance until defined milestones. This makes CCDs a preferred choice for growth-stage companies balancing regulatory compliance with funding flexibility.

Legal Framework:

- a. Under the Companies Act, 2013:
 - i. Governed by Section 71 and Rule 18 of the Companies (Share Capital and Debentures) Rules, 2014, which mandate disclosure of conversion terms, tenure, and approval requirements for issuing debentures.
 - ii. Further regulated by Rule 2(1)(c)(ix) of the Companies (Acceptance of Deposits) Rules, 2014, which exempts Compulsorily Convertible Debentures (CCDs) from being treated as “deposits” when conversion terms are fixed upfront.
- b. Under the Foreign Exchange Management (Non-Debt Instruments) Rules, 2019:
 - i. Classified as “equity instruments” under Rule 2(v)(iii) and Schedule I, allowing foreign direct investment (FDI), subject to pricing norms, sectoral caps, and reporting obligations.
- c. Judicial Precedent:
 - i. The Supreme Court in IFCI Ltd. v. Sutanu Sinha¹ held that CCDs are equity securities, not debt instruments, as they do not involve repayment of principal.

5. Convertible Notes (CNs)

Convertible notes are short-term debt instruments that may convert into equity when the company raises its next round or hits a defined trigger. Recognised for DPIIT-registered startups, they simplify early fundraising before valuation discovery.

Characteristics:

- a. Hybrid Nature: Structured as debt that may convert into equity upon a future financing or trigger event.
- b. Conversion or Repayment: Must either convert or be repaid within ten years from the date of issue.
- c. Investment Threshold: Minimum investment of ₹25 lakh in a single tranche per investor.
- d. Economic Terms: Typically include a valuation cap, discount, or “most-favoured-nation” clause to reward early risk.

¹ 2019 SCC OnLine SC 1462

- e. **Regulatory Treatment:** Recognised for startups registered with the Department of Promotion of Industry and Internal Trade (DPIIT) and treated as “equity instruments” under the Foreign Exchange Management (Non-Debt Instruments) Rules, 2019 upon conversion.

Use Cases:

Convertible notes are commonly used in seed or bridge funding rounds where startups seek quick capital before a formal valuation is established. They allow investors to participate early with the option to convert into equity at a discount during the next priced round. This structure helps founders raise interim funds efficiently while deferring dilution and compliance burdens until a later stage.

Legal Framework:

- a. Under the Companies Act, 2013:
 - i. Convertible notes are treated as unsecured debt instruments that may convert into equity upon specified triggers. Their issuance and conversion are governed by Section 62(3), which allows the conversion of debt into equity through a special resolution approved by shareholders.
 - ii. Under Rule 2(1)(c)(xvii) of the Companies (Acceptance of Deposits) Rules, 2014, convertible notes issued by a DPIIT-recognised startup are exempt from being treated as deposits, provided that conversion or repayment occurs within ten years from the date of issue.
- b. Under the Foreign Exchange Management (Non-Debt Instruments) Rules, 2019:
 - i. Defined under Rule 2(vi) and Schedule I, Paragraph 7, convertible notes may be issued only by DPIIT-recognised startups to resident or non-resident investors.
 - ii. The minimum investment amount must be ₹25 lakh or more per investor in a single tranche, and the instrument must convert into equity or be repaid within ten years.
 - iii. Investments are subject to sectoral caps, pricing guidelines, and reporting as prescribed by the Reserve Bank of India (RBI) under Notification No. FEMA.377/2017-RB, dated 10 January 2017.

6. Redeemable Debentures

Redeemable debentures are traditional debt securities through which a company borrows capital for a fixed term, paying interest and repaying principal at maturity. They do not convert into equity and carry no ownership rights.

Characteristics:

- a. **Fixed Tenure:** Issued for a defined period with mandatory redemption of principal at maturity.
- b. **Interest-Bearing:** Carry a fixed or floating coupon, payable periodically regardless of company profits.

- c. Priority in Repayment: Rank senior to shareholders during liquidation or winding up.
- d. Security Structure: May be secured against company assets or remain unsecured, depending on issuance terms.
- e. Regulatory Nature: Treated as pure debt instruments under the Companies Act, 2013 and governed by the Foreign Exchange Management (Borrowing and Lending) Regulations, 2018 for foreign investment.

Use Cases:

Appropriate for mature or cash-flow-positive startups such as renewable energy, logistics, or infrastructure ventures, that can service regular interest payments. Redeemable debentures are also used for bridge financing or structured debt rounds where founders prefer to avoid dilution.

Legal Framework:

- a. Under the Companies Act, 2013:
 - i. Redeemable debentures are governed by Section 71 and Rule 18 of the Companies (Share Capital and Debentures) Rules, 2014, prescribing conditions for issuance, redemption, and creation of security.
 - ii. When secured, a charge must be registered with the Registrar of Companies in Form CHG-9 under Section 77 and the Companies (Registration of Charges) Rules, 2014.
 - iii. Under Rule 2(1)(c)(ix) of the Companies (Acceptance of Deposits) Rules, 2014, redeemable or secured debentures are exempt from being treated as deposits if redemption occurs within ten years and the issue is backed by a charge on company assets.
- b. Under the Foreign Exchange Management and Reserve Bank of India framework:
 - i. For non-resident investors, redeemable debentures are classified as debt instruments under Rule 2(1)(v) of the Foreign Exchange Management (Debt Instruments) Rules, 2019, read with the Foreign Exchange Management (Borrowing and Lending) Regulations, 2018.
 - ii. Such issuances must comply with the External Commercial Borrowing (ECB) framework, including the Master Direction on External Commercial Borrowings, Trade Credits and Structured Obligations, 2022, issued by the Reserve Bank of India.
 - iii. Borrowings are subject to eligible borrower and lender criteria, end-use restrictions, all-in-cost ceilings, and reporting requirements in Form ECB through the Authorised Dealer Bank.

Evaluating the Appropriate Instrument for Startup Financing

The determination of an appropriate corporate finance instrument requires a calibrated assessment of legal structure, commercial objectives, and investor expectations. The choice influences not only ownership and governance but also valuation outcomes, compliance intensity, and the financial flexibility of the enterprise. From an investor's standpoint, the instrument defines the degree of control, protection, and exit feasibility. The following key factors assist in evaluating the appropriate structure for startup fundraising in India.

1. Dilution

Each funding round inevitably results in ownership dilution. Equity-based instruments, such as equity shares and CCPS, cause immediate dilution but align investor returns with enterprise performance. Convertible instruments, such as CCDs and convertible notes, allow deferment of dilution until a valuation or conversion event occurs.

Investors generally prefer instruments that preserve proportional ownership or offer anti-dilution protection, ensuring protection against future down-rounds and valuation adjustments.

2. Stage and Valuation

The stage of growth and valuation maturity are decisive considerations. Early-stage entities, where valuations are fluid, may employ convertible notes to avoid premature pricing. In contrast, growth or Series A–C stage startups may issue CCPS or CCDs, which provide structured valuation and governance rights.

Investors typically favour convertible or hybrid instruments at early stages to mitigate valuation uncertainty and shift to equity-linked structures once financial stability and growth predictability are established.

3. End Use of Funds

The intended purpose of capital utilisation directly impacts the choice of instrument. Equity and convertible instruments are more suitable for long-term strategic expansion, while debt instruments, such as redeemable debentures, are appropriate for short-term or revenue-generating activities with defined repayment capacity.

Investors prefer aligning the instrument with the risk profile of the end use—equity for capital expansion and debt for stable, cash-flow-backed projects.

4. Managerial and Operational Control

Instruments differ in the level of governance rights they confer. Direct equity and CCPS offer voting and participation rights under the *Companies Act, 2013*, whereas CCDs and convertible notes provide economic participation without immediate control.

Strategic or late-stage investors often seek governance influence, while early-stage investors may prioritise economic participation and information rights without operational interference.

5. Securitization

Startups with tangible assets may issue secured debentures, creating a charge over assets to mitigate credit risk. Conversely, asset-light or technology-based startups generally rely on equity or hybrid instruments.

6. Liquidity Foreseeability

Where cash-flow visibility is limited, equity or CCPS structures are more appropriate as they carry no repayment obligations. Debt instruments, requiring periodic interest or redemption, suit ventures with stable liquidity.

Investors assess liquidity to balance return certainty and risk exposure, preferring equity in growth phases and debt where repayment is foreseeable.

7. Tenure

The intended duration of investment influences the structure of investment. Long-term capital typically employs CCPS or CCDs, aligning with future exit or listing events. Shorter-term bridge funding may be structured through convertible notes or redeemable debentures.

Investors with extended investment horizons prefer equity-linked instruments offering appreciation potential, whereas those seeking fixed returns or early exits prefer shorter-tenure debt-based instruments.

Conclusion

Choosing the right investment instrument is both an opportunity and a responsibility. An appropriate structure can unlock long-term value, attract credible investors, and ensure compliance throughout the company's growth journey. Conversely, a poorly chosen instrument may result in avoidable dilution, regulatory non-compliance, or financial rigidity. Founders must, therefore, evaluate each option not only for its immediate funding potential but also for its legal, tax, and governance implications. A well-considered choice balances flexibility with accountability by safeguarding the company's interests while maintaining investor confidence and regulatory alignment in India's evolving startup ecosystem.

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