

RAISING FOREIGN INVESTMENT IN INDIA: FEMA AND FDI COMPLIANCE ESSENTIALS

(Startup Fundraising Series, Part VII – November 19, 2025)

Cross-border fundraising has become an essential component of the capital strategy for Indian startups and growth-stage companies, particularly those operating in technology-driven and globally scalable sectors. As venture capital and private equity increasingly flow through international structures, founders are required to navigate a regulatory landscape that is both sophisticated and compliance-intensive. At the centre of this framework lies the Foreign Exchange Management Act, 1999 (“**FEMA**”), which governs all inbound and outbound capital account transactions and establishes the overarching principles for India’s foreign investment regime.

Foreign direct investment into India is primarily regulated under the FEMA (Non-Debt Instruments) Rules, 2019, read with the Consolidated FDI Policy and relevant press notes, including Press Note 3 of 2020 issued by the Department for Promotion of Industry and Internal Trade, which introduced additional scrutiny for investments originating from countries sharing land borders with India. Overseas investments by Indian entities, including the increasingly common use of offshore holding structures, are governed by the FEMA (Overseas Investment) Rules, 2022 and the corresponding Overseas Investment Regulations, 2022. Further, foreign borrowing arrangements fall under the External Commercial Borrowings (“**ECB**”) Framework, issued pursuant to Foreign Exchange Management (Borrowings and Lending) Regulations, 2018, which distinguishes debt-based inflows from equity-based foreign investment.

Within this ecosystem, compliance serves not merely as a procedural requirement but as a strategic imperative. Pricing guidelines, sectoral caps, entry routes, and post-investment reporting, such as filings in **Form FC-GPR**, **Form FC-TRS** are central to ensuring regulatory validity. Non-compliance may trigger the enforcement provisions under Section 13 of FEMA, often leading to compounding or other remedial obligations.

This article provides a practitioner-focused overview of the key components of cross-border fundraising, including the distinction between ECB and FDI, classification of equity instruments, FDI and ODI compliance frameworks, valuation norms, sectoral restrictions, round-tripping considerations, and the practical limitations that founders must carefully account for while structuring international capital flows.

Regulatory Architecture Governing Cross-Border Capital Flows

Cross-border fundraising by Indian companies is governed by a layered and interdependent regulatory framework, primarily driven by FEMA and supplemented by RBI directions, DPIIT policies, and corporate law requirements. Understanding this architecture is essential for structuring compliant inbound and outbound transactions, particularly where investments involve equity, debt, hybrid instruments, or multi-jurisdictional holding structures. The following sub-sections outline the principal statutes, regulations, and institutional bodies that collectively shape India’s foreign investment landscape.

1. FEMA as the Foundational Framework

India's foreign exchange regime is rooted in the FEMA, which distinguishes current account transactions from capital account transactions. Capital account transactions, including the issue or transfer of securities, are regulated under Section 6(2A) of the FEMA. This empowers the Reserve Bank of India ("RBI") to frame rules and regulations governing foreign investment, thereby establishing FEMA as the primary statutory framework for all cross-border capital flows.

2. Core Regulations Governing Inbound and Outbound Capital

- (a) FEMA (Non-Debt Instruments) Rules, 2019 ("**NDI Rules**"): The NDI Rules govern Foreign Direct Investment (FDI) in India, specifying permissible instruments, entry routes, sectoral caps, pricing guidelines, downstream investment norms, and reporting obligations. They operate in conjunction with the Consolidated FDI Policy issued by the Department for Promotion of Industry and Internal Trade ("**DPIIT**") and press notes such as Press Note 3 of 2020, which subjects investments from countries sharing land borders with India to government approval.
- (b) FEMA (Overseas Investment) Rules, 2022 and Overseas Investment Regulations, 2022 ("**ODI Framework**"): Outbound investments by Indian entities and individuals are governed under this consolidated framework. The FEMA (Overseas Investment) Rules, 2022 define Overseas Direct Investment (ODI), Overseas Portfolio Investment (OPI), "control", "financial commitment", and stipulate eligibility norms, prohibitions (including restrictions on round-tripping), and reporting requirements such as Form FC, Annual Performance Report (APR), and OPI filings.
- (c) External Commercial Borrowing ("**ECB**") Framework: Foreign borrowings are regulated under the ECB Framework prescribing eligible borrowers and lenders, recognised debt instruments, minimum average maturity, all-in-cost ceilings, end-use restrictions, and reporting via Form ECB and ECB-2 returns.

3. Interactions with Other Statutes and Regulators

Corporate processes relating to issuance or transfer of securities are governed by the Companies Act, 2013, particularly Section 42 (private placement), Section 62 (preferential allotment), and Rule 13 of the Companies (Share Capital and Debentures) Rules, 2014 (valuation). Tax considerations under the Income-tax Act, 1961, including transfer pricing and indirect transfer rules, also influence structuring.

Regulatory oversight is shared among the RBI, DPIIT, Authorised Dealer Category-I Banks, and Ministry of Corporate Affairs, each playing a distinct role in facilitating and enforcing cross-border investment compliance.

FDI vs ECB: Capital Classification and Permissible Fundraising Instruments under FEMA

A correct classification of inbound capital as either equity or debt is fundamental to determining the regulatory pathway under FEMA. Since every cross-border infusion must fall within either the NDI Rules or the ECB Framework, the nature of the instrument directly affects valuation, sectoral permissibility, investor rights, and long-term fundraising strategy.

1. Foreign Direct Investments under FEMA

FDI is governed by Section 6(2A) of FEMA, which empowers the RBI to regulate the issue or transfer of securities to non-residents. The NDI Rules operationalise this framework by specifying sectoral caps, entry routes, pricing norms, and the set of instruments that qualify as *equity instruments* for FDI purposes. FDI represents long-term participation in the capital structure of the Indian company and typically confers ownership, economic entitlement, and governance rights.

2. External Commercial Borrowings under FEMA

In contrast, foreign debt inflows are governed by the ECB Framework issued under FEMA 3/2000-RB, as amended. ECBs encompass loans, non-convertible debentures, bonds, and masala bonds sourced from recognised lenders. These instruments create fixed repayment obligations linked to interest, tenure, and cost ceilings, thereby positioning ECB as a debt-based fundraising route suitable for entities with stable revenues or asset-backed operations.

3. Equity Instruments Eligible for FDI (NDI Rules)

Rule 2(k) of the NDI Rules recognises the following as *equity instruments* eligible for FDI:

- (a) Equity shares, including partly paid shares subject to prescribed payment schedules;
- (b) CCPS and CCDs, provided they are *mandatorily convertible* into equity shares in accordance with the terms of issue;
- (c) Share warrants, subject to upfront payment of at least 25% of the consideration and mandatory conversion within the stipulated period;
- (d) Convertible notes issued by DPIIT-recognised startups, being instruments convertible into equity or repayable within the prescribed tenure.

A consistent legislative principle emerges: only instruments that are *fully and mandatorily convertible* qualify as equity instruments. Instruments containing optionality—such as optionally convertible preference shares, optionally convertible debentures, redeemable securities, or hybrid instruments lacking mandatory convertibility do not qualify for FDI and cannot be issued to non-residents under the NDI Rules.

4. Debt Instruments under the ECB Framework

Instruments that do not satisfy the definition of equity instruments fall within the ECB Framework. These include foreign currency loans, non-convertible debentures, bonds, and any other borrowing instrument carrying repayment obligations. From a regulatory perspective, ECBs constitute contractual debt and therefore do not confer ownership, voting, or governance rights.

5. Key Distinction between FDI and ECB

FDI represents equity capital, linked to ownership and governed by sectoral caps and pricing norms under the NDI Rules. ECB represents foreign debt governed by cost ceilings, maturity standards, and end-use restrictions. FDI typically aligns with growth-stage and venture financing where investors seek governance rights and long-term participation. ECB is suitable for established businesses requiring leverage without dilution, subject to the constraints of the ECB Framework.

Sectoral Caps, Entry Routes, and Press Note 3 Conditions

India's foreign investment regime operates on the principle that FDI is permitted unless expressly restricted; however, the extent of permissible investment, and whether it may be received without prior approval, is determined by sectoral caps and entry routes prescribed under the NDI Rules. These sectoral conditions constitute a central compliance checkpoint before structuring any cross-border fundraising.

1. Legal Basis for Sectoral Regulation

The authority to regulate the issuance and transfer of securities to non-residents flows from Section 6(2A) of FEMA. This statutory framework is operationalised through the NDI Rules, particularly Rule 6 of the NDI Rules, which categorises foreign investments into the *Automatic Route* and the *Government Route*. Sector-specific conditions are set out in Schedule I of the NDI Rules and are aligned with the Consolidated FDI Policy issued by DPIIT.

2. Automatic Route v. Government Route

Under the *Automatic Route*, foreign investment does not require prior Government approval, provided the corresponding sector is listed as open under Schedule I. Most technology, SaaS, marketplace e-commerce, manufacturing, and services sectors fall within this category.

The *Government Route* requires prior approval from the relevant administrative ministry or department before the capital may be received. Illustrative sectors under this category include:

- (a) Defence (FDI permitted up to 74% under the Automatic Route; beyond this, Government approval is required);
- (b) Telecom services beyond 49%;

- (c) Digital media (26% under the Government Route);
- (d) Financial services not regulated by a financial sector regulator;
- (e) Print and broadcasting media (various limits across activities).

Sectoral allocation between these routes is governed by Schedule I of the NDI Rules read with applicable sectoral guidelines.

3. Sectoral Caps and Prohibited Sectors

Schedule I prescribes numerical caps for specific sectors. Common thresholds relevant to startup and technology-driven businesses include:

- (a) E-commerce marketplace models: 100% under the Automatic Route, subject to explicit operational conditions;
- (b) Telecom: 100% permitted; investment beyond 49% requires Government approval;
- (c) Brownfield pharmaceuticals: up to 100%, but under the Government Route due to public interest considerations;
- (d) Digital media: 26% under the Government Route.

Certain activities are expressly prohibited for FDI under Schedule I, including:

- (a) Lottery and gambling activities;
- (b) Nidhi companies;
- (c) Real estate business (other than construction development);
- (d) Manufacturing of tobacco products

4. Press Note 3 of 2020: Investments from Land-Bordering Countries

Press Note 3 introduced an additional regulatory layer by mandating that any investment by an entity of a country sharing a land border with India, or where the *beneficial owner* of the investment is situated in such a country, requires prior Government approval.

In practice, this framework requires:

- (a) beneficial ownership review tracing direct and indirect ownership;
- (b) Government approval even for downstream investments where the investor already holds PN3-sensitive foreign investment; and

- (c) Enhanced scrutiny for VC/PE funds with limited partners located in Press Note 3 jurisdictions.

5. Practical Considerations

Founders must assess sectoral caps and entry routes at the term sheet stage to avoid subsequent regulatory roadblocks. PN3 analysis must be undertaken early, particularly for funds with multi-jurisdictional LP structures. Structuring choices, whether via FDI, ODI, or offshore entities, should be aligned with applicable sectoral limits, valuation expectations, and investor exit rights.

FDI Reporting and Compliance under FEMA

The FDI regulatory framework places significant emphasis on post-investment and transfer-related reporting, forming a central element of FEMA compliance. Reporting obligations serve two purposes: ensuring adherence to pricing and sectoral norms under the NDI Rules, and providing RBI with a consolidated view of foreign investment through the FIRMS Portal. The statutory authority for such reporting flows from Rule 20 of the NDI Rules and the Master Directions on Reporting governing the Single Master Form.

1. Preconditions for FDI Reporting

Before initiating a filing, Indian companies must ensure compliance with corporate authorisations under the Companies Act, 2013, including board approval and, where applicable, shareholder approval for private placements or preferential allotments, as applicable.

Valuation is governed by Rule 21 of the NDI Rules, which requires that the issuance or transfer of equity instruments to a non-resident adhere to fair valuation using an internationally accepted pricing methodology. KYC compliance at the AD Bank level is a mandatory precursor to any FEMA reporting.

2. FC-GPR – Reporting of Issue of Equity Instruments

In accordance with Rule 20 of the NDI Rules read with Par IV of the Master Directions – Reporting under Foreign Exchange Management Act, 1999 issued by the RBI (updated as on September 16, 2024) (“**Master Directions on Reporting**”), an Indian company issuing equity instruments to a non-resident must file Form FC-GPR within *30 days of allotment*. This applies to equity shares, CCPS, CCDs, share warrants, and convertible notes.

The filing requires submission of the valuation certificate, board/shareholder resolutions, details of the allotment, and the FIRC and KYC documents issued by the AD Bank. Instruments such as partly paid shares and warrants must comply with the conversion timelines stipulated in Schedule I.

3. FC-TRS – Reporting of Transfer of Equity Instruments

Transfers of equity instruments between a resident and a non-resident (or vice versa), and certain transfers between two non-residents where pricing guidelines are applicable, must be reported in Form FC-TRS pursuant to Rule 20 of the NDI Rules read with Par IV of the Master Directions on Reporting.

The filing must be completed within *60 days of transfer of the instrument*. Pricing must conform to the valuation norms under Rule 21 of the NDI Rules, and the AD Bank is required to verify compliance before approving the submission.

4. Downstream Investment Reporting (DI Filings)

Downstream investment obligations arise when an Indian entity with foreign investment makes equity investments in another Indian entity. Such transactions must comply with sectoral caps, entry routes, and pricing norms applicable to the receiving entity.

Reporting is mandated under Rule 23(5) of the NDI Rules and must be completed within *30 days of the investment*. Downstream investments must be made at arm's length and should not result in a structure that violates conditions applicable to foreign-owned or controlled companies.

5. Consequences of Non-Compliance

Delayed or incorrect filings attract a Late Submission Fee (LSF) as prescribed by RBI. More serious contraventions may be adjudicated under Section 13 of FEMA, potentially requiring compounding or incurring monetary penalties. Non-compliance also raises diligence concerns in subsequent fundraising rounds and may impede cross-border structuring initiatives.

Valuation Norms for FDI under FEMA

Valuation plays a central role in cross-border fundraising, ensuring that foreign investment into India adheres to FEMA's capital account safeguards. The NDI Rules establish a mandatory pricing regime for both issuance and transfer of equity instruments to prevent under-valuation and over-valuation of foreign capital. The governing framework is set out in Rule 21 of the NDI Rules, read with the reporting requirements under Rule 20 of NDI Rules.

1. Valuation for Primary Issuance (FC-GPR Transaction)

For issuance of equity instruments to non-residents, Rule 21(2) of the NDI Rules stipulates that the issue price must be equal to or higher than the fair market value of the equity instruments. Valuation must be undertaken using an "internationally accepted pricing methodology" on an arm's-length basis and certified by a SEBI-registered merchant banker or a chartered accountant.

This requirement applies to all equity instruments recognised under Rule 2(k), including equity shares, CCPs, CCDs, and share warrants. In the case of partly paid shares and warrants, pricing must be determined upfront to ensure that subsequent calls or conversions do not violate the minimum pricing norms.

Convertible instruments such as CCPs and CCDs must be issued at a price not lower than the fair value determined at the time of issuance. The **conversion formula** must be fixed upfront and must not provide for a lower conversion price than what may be permissible at the time of issuance.

2. Valuation for Transfer of Shares (FC-TRS Transactions)

Transfers between residents and non-residents must comply with Rule 21(3):

- (a) When a resident transfers to a non-resident, the transfer price cannot be less than the fair market value.
- (b) When a non-resident transfers to a resident, the transfer price cannot be higher than the fair market value.

This framework ensures that capital does not move out of India below fair value and that residents do not overpay for foreign holdings. The same valuation methodologies apply, and certification is typically required by a merchant banker or CA. The pricing norms also apply to secondary transfers during funding rounds and, in certain cases, transfers between non-residents where specific conditions are triggered.

3. Startup Specific Considerations

Eligible startups may issue convertible notes, which offer deferred pricing flexibility at issuance. Valuation is determined at the time of conversion in accordance with the pricing norms applicable on that date. This structure is particularly useful for early-stage companies where valuation discovery is still evolving.

Limitations and Regulatory Constraints for Cross-Border Fundraising

Despite the relatively liberalised cross-border investment regime, Indian startups encounter several practical constraints when negotiating and closing foreign fundraising transactions. These limitations arise not only from the technical framework under FEMA, but also from operational requirements imposed by valuation norms, sectoral classifications, AD Bank scrutiny, and investor expectations.

1. Limits on Structuring Investor Returns

While investors often seek certainty on returns or exit values, FEMA restricts any form of assured return on equity instruments due to the pricing norms under Rule 21 of the NDI Rules. As a result, startups cannot offer guaranteed IRR, fixed buyback values, or

redemption-based exits to non-residents. Instead, commercial negotiations must rely on venture-standard protections such as liquidation preference, anti-dilution adjustments, conversion formulas, and governance rights. Term sheets must be drafted carefully to avoid constructs that may be interpreted as guaranteed payouts.

2. Structuring and Jurisdictional Constraints Affecting Investor Participation

Sectoral caps and entry routes can restrict the composition of a startup's investor base. For example, certain fintech and media models require prior Government approval irrespective of valuation or instrument type. Similarly, Press Note 3 requires heightened scrutiny where the investor, or its beneficial owner, is situated in specific jurisdictions. In practice, this means startups should undertake sectoral and jurisdictional mapping at the preliminary stage to avoid disruptions during closing.

3. Limited Flexibility in Choice of Instruments

Startups cannot issue optionally convertible or redeemable instruments to foreign investors, as FDI permits only mandatory convertible instruments under Rule 2(k) of the NDI Rules. Investors seeking quasi-debt structures must achieve their economic objectives through CCPS or CCD terms, rather than redemption or put-style obligations. This limits the ability to structure downside protection purely through instrument design.

4. Constraints on Secondary Transaction and Exit Planning

FEMA pricing norms can restrict the valuation at which promoters or existing investors undertake secondary sales. Transfers below fair value, buybacks at negotiated discount prices, or ESOP liquidity events may not be permissible. This can limit down-round clean-ups or early partial exits. Founders must therefore anticipate FEMA pricing implications when structuring both primary and secondary components of a fundraising round.

5. AD Bank Scrutiny and Documentation Requirements

In practice, AD Banks act as functional gatekeepers for FEMA compliance. They may require detailed supporting documentation, including valuation certificates, FIRC's, KYC, and board approvals, before processing FC-GPR or FC-TRS filings. Delays at the AD Bank level often result in missed statutory timelines, triggering exposure to Late Submission Fees or, in some cases, compounding under Section 13 of FEMA. Startups should therefore maintain a complete transaction file and build timing buffers into their closing schedule.

Conclusion

Cross-border fundraising continues to be a cornerstone of growth for Indian startups, but its effectiveness depends on how well founders navigate the legal and regulatory environment governing foreign capital. The FEMA framework, particularly the NDI Rules and the ECB Framework, establishes the boundaries within which foreign investment may be structured, valued, and reported. These rules are not merely procedural, they shape the commercial feasibility of transactions, influence investor participation, and determine the long-term

legal soundness of fundraising decisions. For startups seeking to engage with global investors, a clear and practical understanding of this framework has become an indispensable part of the fundraising process.

In practice, several considerations materially affect the fundraising process. Startups must classify their business model early to assess sectoral caps and eligibility conditions under the NDI Rules, particularly where Government approval or Press Note 3 sensitivities may apply. Valuation alignment is equally critical: ensuring consistency between term-sheet economics, Companies Act requirements, and the pricing guidelines under Rule 21 prevents avoidable delays or later compliance challenges. Choosing the appropriate instrument, most commonly CCPS with a well-defined conversion formula, allows investors to achieve economic protection while remaining within FEMA's restrictions on assured returns and redemption-linked obligations.

Operational preparedness plays a vital role. Maintaining a compliance-ready documentation set, including valuation reports, FIRC's, KYC records, and board/shareholder approvals, helps manage scrutiny at the AD Bank level and ensures timely FC-GPR or FC-TRS filings. This discipline becomes particularly important because any lapse in an earlier round tends to surface during due diligence for subsequent rounds, sometimes necessitating remediation or compounding under Section 13 of FEMA.

Ultimately, cross-border fundraising rewards founders who embrace a governance-led approach anticipating regulatory constraints, structuring investor rights thoughtfully, and embedding compliance into their capital strategy. By doing so, startups position themselves for smoother negotiations, stronger investor confidence, and sustained growth in an increasingly global capital environment.

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