

Legalogic



FDI Policies, Structures, Sectoral Caps, Prohibited Sectors

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Applicability of FEMA

REGULATION IS BASED ON



Residential Status

Whether the person is resident in India or outside India



Nature of Transaction

Whether it is a current or capital account transaction



FEMA does NOT apply

- Between two residents, unless it is an overseas transaction
- Between two non-residents, unless it is for an Indian transaction



FEMA still applies

- Foreign branches & overseas JV / wholly-owned subsidiaries
- Residents outside India
- Immovable property — citizens of specified countries, irrespective of residential status

Entry Strategy into India

Foreign investors can enter India through four principal routes; each is governed differently under FEMA.



Foreign Direct Investment (FDI)

Equity capital in Indian companies via the automatic or government approval route.



External Commercial Borrowings

Foreign loans raised by eligible Indian borrowers from recognised overseas lenders.



LO / BO / PO

Liaison, Branch or Project Office set up in India by a foreign entity.



Other than FDI

Non-FDI modes such as FPI, FVCI and other permitted foreign investments.

Foreign Direct Investment (FDI) in India



FDI is a key channel for overseas investors to participate in Indian companies, sectors and growth opportunities.



India permits FDI in most sectors

Subject to prescribed entry routes, ownership caps and sector-specific conditions.

Four threshold questions for any Proposed FDI Transaction

1

Is the sector open?

2

What is the cap?

3

Is approval required?

4

Any special conditions or restrictions?



FDI is not just about who invests

It is about who ultimately owns or controls, which instrument, which sector, and what happens downstream

Foreign Investment

Foreign Investment — Investment that meets all three conditions:



Equity instruments

of an Indian company or the capital of an
LLP



By a non-resident

made by a person resident outside India



Repatriable basis

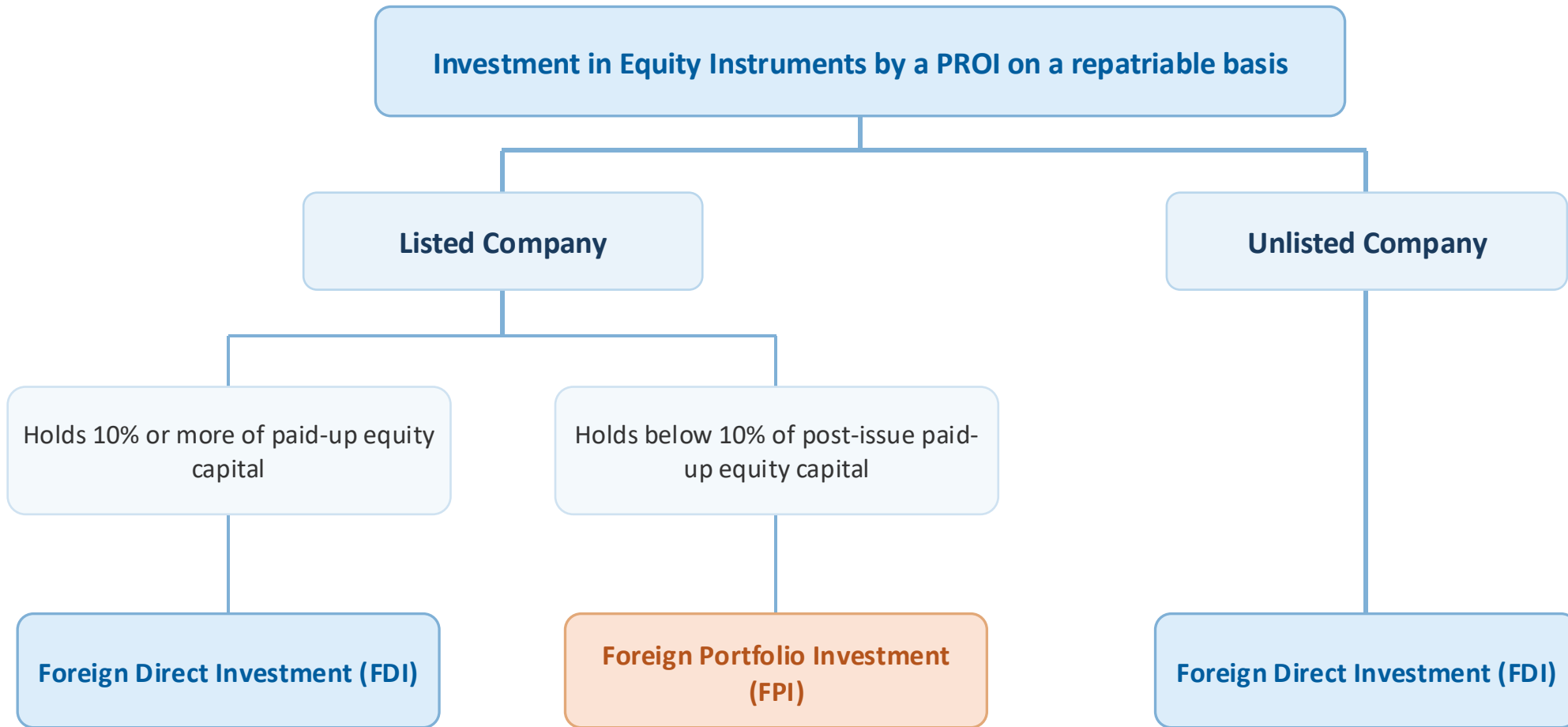
held on a repatriable basis

Non-resident may hold foreign investment as **FDI** or **FPI**.



Residency, not nationality, drives the FEMA analysis.

FDI vs. FPI



Why FDI Matters?



Sets the rules: FDI policy determines who can invest, how, and on what terms.



Value-add: Professionals drive structuring, valuation, due diligence and compliance.



Cost of getting it wrong: Non-compliance brings delayed closings, penalties, scrutiny and exit hurdles.



Cuts across domains: FDI overlaps with tax, the Companies Act, M&A, ESOPs, beneficial ownership and sector rules.



Whole lifecycle: Compliance must be tested across the full investment lifecycle, not only at entry.



Many FEMA issues do not arise at entry. They surface at the next transaction

Key Elements of the FDI Regime



Entry Route: Determine whether the investment falls under the Automatic or Government Route



Sectoral Classification & Conditions: Identify the activity and applicable FDI policy sector; review caps, conditionalities and restrictions



Investment Instruments: Ensure the investment is made through a permitted instrument and a permitted structure



Restricted or Prohibited Sectors: Certain activities remain closed to FDI (lottery, gambling, etc.)



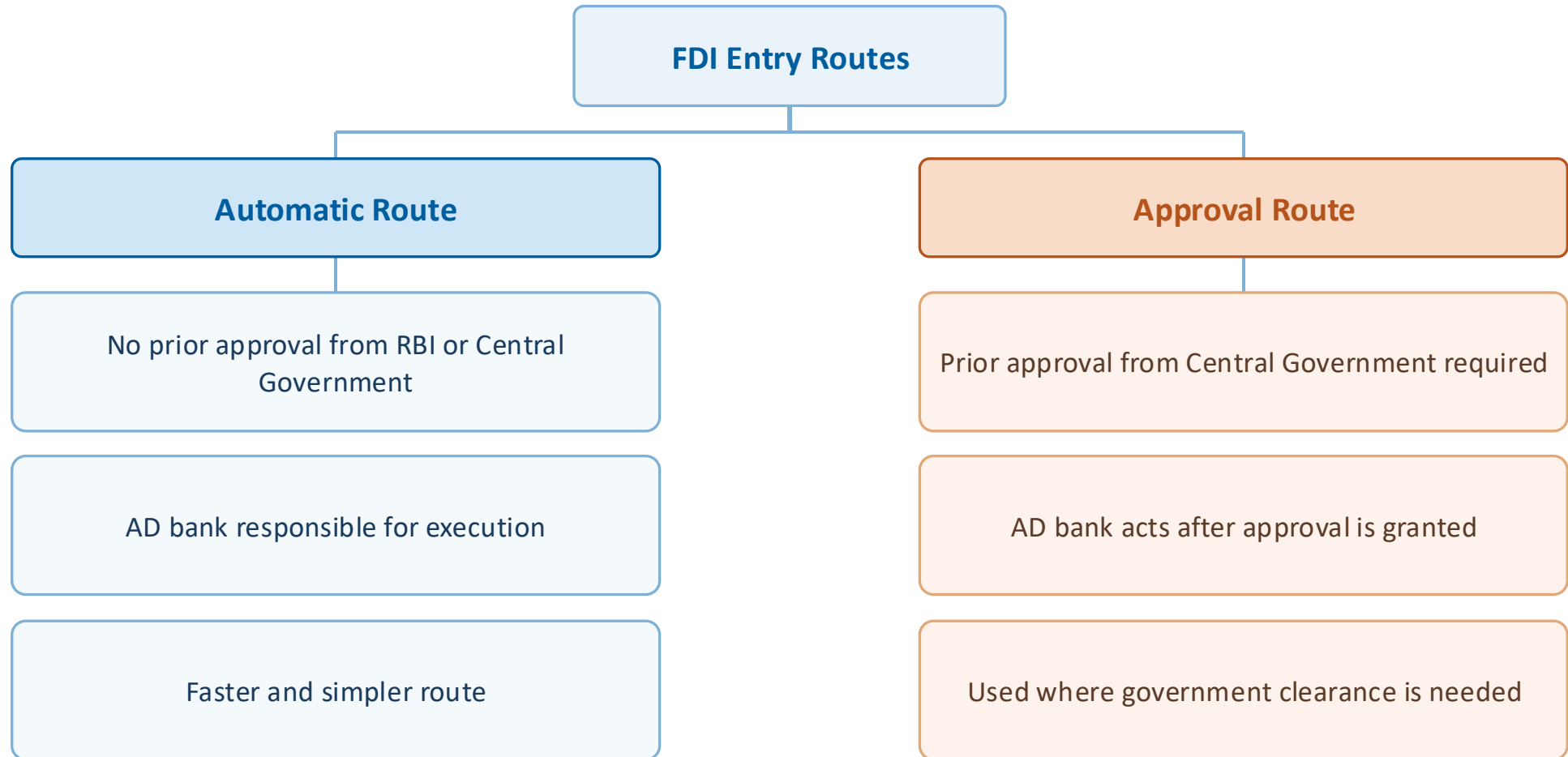
Compliance Overlay: Pricing guidelines, beneficial-ownership checks, Press Note 3, and post-investment reporting.



FDI analysis rarely turns on one source.

Real skill is reconciling FEMA, the policy, RBI directions, sector rules and the Companies Act together.

FDI Routes



Entry Route: Practical Considerations



Automatic Route

No prior approval — but compliance still applies.



Government Route

Adds approval steps — affects timelines & certainty.

Route analysis shapes key deal terms, Settle it at the term-sheet stage



Conditions precedent



Long-stop dates



Regulatory covenants



Funding timelines



Termination rights



Wrong route analysis is not just a compliance problem. It is a deal-execution problem.

Sectoral Caps: Practical Considerations



Right sector first: Identify the sector from actual business activities, not just the object clause



Composite caps: Account for direct plus indirect foreign investment together



Conditions matter: Sectoral conditions are as important as the cap itself



Mixed models: Multiple business lines may trigger several sector-specific regimes



Control impact: Sectoral caps can shape governance and control rights



Real issue is often not the cap. It is identifying the correct sector.

Issuance of Equity Instrument and Deferred Payment



Equity Instruments

- Equity shares
- Convertible debentures
- Preference shares
- Share warrants



Partly Paid Shares

- Minimum 25% of consideration upfront
- Balance within 12 months of issue



Share Warrants

- Minimum 25% of consideration upfront
- Balance within 18 months of issue



Only fully and mandatorily convertible instruments count as equity. Anything optionally or non-convertible is treated as debt.

Commercial Objectives vs. FEMA Constraints

Is the client solving a business need through an instrument that creates a FEMA issue?



Downside protection

Investor



Delayed dilution

Promoter



Milestone infusion

Both parties



Control retention

Family business

Important to translate commercial intent into a compliant instrument design



In sensitive sectors, governance rights must be negotiated with FEMA awareness. Not only with commercial enthusiasm.

FDI Not Permitted



Prohibited sectors: Foreign investment is barred in certain sectors under the FDI Policy



Land-border entities: Investors from countries sharing a land border with India need prior Government approval (Press Note 3)



Beneficial ownership: Investments whose beneficial owner is from a land-bordering country also require approval



Pakistan: Citizens and entities need approval and are barred from defence, space, atomic energy and other prohibited sectors



Press Note 3 approval is case-by-case

Sector, strategic importance of the investment and national-security considerations all shape the outcome

Prohibited Sectors



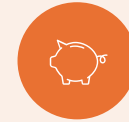
Lottery business



Gambling & betting



Chit funds



Nidhi companies



Trading in TDRs



Real estate & farmhouses



Tobacco manufacturing



Atomic energy & railways



Foreign technology collaboration — licensing of franchise, trademark, brand name or management contracts — is also prohibited for lottery and gambling/betting activities.

Prohibited Sectors: Key Considerations



Indirect exposure: Prohibited-sector exposure can arise through business models or group structures.



Look past documents: Review actual business activities, not just constitutional documents.



Assess the operations: Examine revenue streams, licences, contracts and operational activities.



Check the group: Consider activities undertaken by subsidiaries and group entities.



If the business model points to a prohibited activity, the foreign-investment thesis can collapse.

Beneficial Ownership: Practical Considerations



Jurisdiction matters: Investor's jurisdiction affects eligibility and approval requirements.



Ultimate ownership: Assess the ultimate beneficial owner, not just the immediate investor.



Look-through diligence: Trace ownership and control structures end to end.



Clarify early: Establish the ownership and control chains at an early stage.



Watch the red flags: SPVs, layered funds, nominee holdings and contractual control rights.



KYC is no longer just onboarding, It is transaction viability analysis.

Deferred Consideration

Up to 25% of total consideration may be deferred in resident–non-resident equity transfers.



Deferred payment

Paid within 18 months of the transfer agreement.



Escrow

Held in escrow for up to 18 months.



Indemnity

Seller indemnifies for up to 18 months after full payment.



Common thread — an 18-month outer limit applies to all three routes.

Deferred Consideration: Structuring Approach



Rule: 25% of total consideration must be paid within 18 months.

If part of the consideration is deferred beyond 24 months, two structuring routes:



Consultancy fees

Taxed as ordinary income - Significantly higher tax rate



Non-voting shares

LTCG applies — More tax-efficient route.



If the SPA consideration is denominated in USD, FX fluctuations could push the deferred consideration above the 25% FEMA threshold.

Acquisition Through Rights Issue/Bonus Issue



Key Conditions

- **No sectoral-cap breach:** Issue must not exceed the applicable FDI sectoral cap.
- **NDI Rules, 2019:** Initial acquisition and shareholding must comply with the FEM (Non-Debt Instruments) Rules, 2019.
- **Non-repatriation basis:** If the shareholder was resident in India, instruments (other than share warrants) are held on a non-repatriation basis.



Pricing Norms

Rights issue

- **Listed:** Price determined by the company.
- **Unlisted:** Not less than the price offered to residents.

Renunciation to a non-resident

- **Listed:** Not less than the price under SEBI regulations.
- **Unlisted:** Not less than fair value, certified by a valuer.

Employee Stock Option Plan Scheme



Eligible recipients: Only employees or directors of the company, its holding company, subsidiary, JV or WOS.



No outsiders: Non-employees are not eligible to receive ESOPs.



Respect sectoral caps: Issue must comply with applicable FDI sectoral caps.



Pricing Guidelines: Do not apply

Non-Cash Consideration- Capitalisation of Dues



Technical Know-how & Royalties

Equity instruments issued against lump-sum technical know-how fees and royalties due to a foreign entity.



Pre-incorporation Expenses

Pre-operative / pre-incorporation expenses incurred by a foreign parent, capitalised through equity issued by the Indian subsidiary.

Cap: 5% of capital or USD 500,000 (whichever is lower).



Both routes are subject to FEMA conditions and RBI reporting requirements.



Downstream Investment

Foreign Investment



Direct Investment

Investment made directly by a non-resident entity or individual into the Indian company.



Indirect Investment

- From another Indian entity that has received foreign investment and is **owned or controlled by non-residents**.
- By an investment vehicle whose sponsor, manager or investment manager is **owned or controlled by non-residents**.



Key test for indirect investment : Whether the upstream Indian entity is owned or controlled by non-residents

Indian Company Will Not Be an FOCC If:

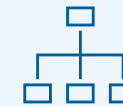
An Indian company is not a Foreign Owned and Controlled Company (FOCC) when both tests are satisfied:



Ownership Test

More than 50% of equity instruments are beneficially owned by resident Indian citizens — or by an Indian company that is itself ultimately owned and controlled by resident Indian citizens.

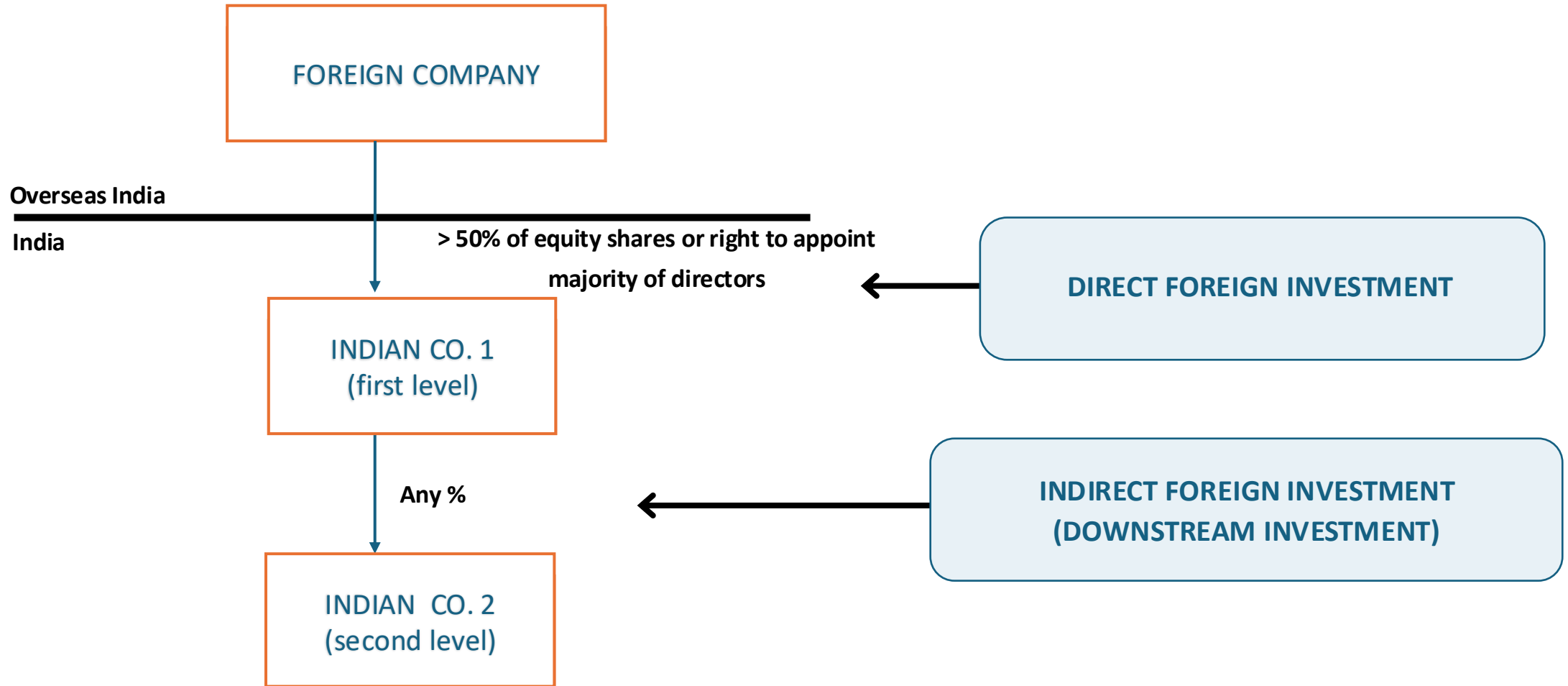
AND



Control Test

Resident Indian citizens — or Indian companies ultimately owned and controlled by them — hold the right to appoint a majority of directors or to control management and policy decisions.

Downstream Investment



Key Conditions for Receiving Downstream Investment



Investee compliance: Entity must comply with applicable entry routes, sectoral caps, and pricing and reporting requirements.



FOCC-LLP limits: Downstream investment only in sectors allowing 100% FDI under the automatic route, with no FDI-linked performance conditions.



Beneficial ownership: Links to a land-bordering country may trigger a Government approval requirement.

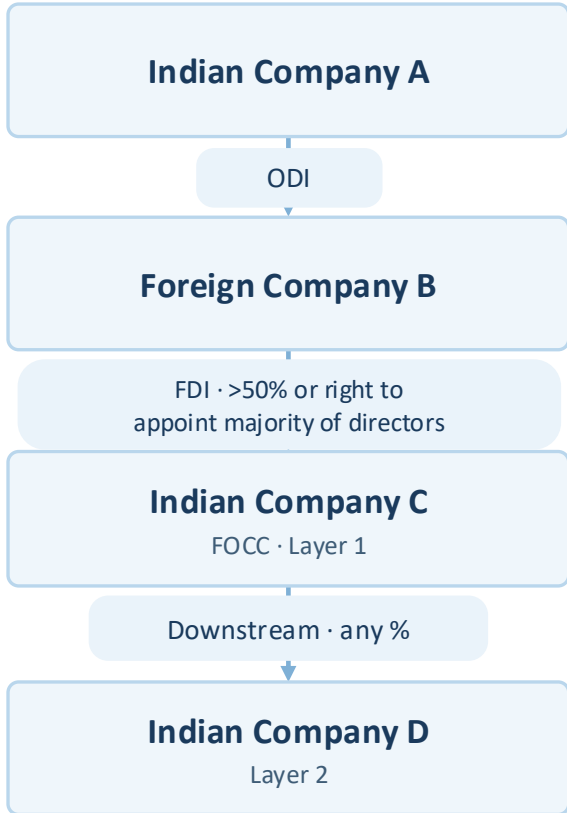


Assess every layer: Each new subsidiary, JV or vertical must be separately assessed, even if the original investment was compliant.



Every new subsidiary, JV or business vertical in a foreign-influenced group should trigger a fresh FDI review.

PERMITTED



Downstream investment permitted up to two layers.

NOT PERMITTED



A third downstream layer is not permitted.

Downstream Investment

Master Direction on Foreign Investment · 20 January 2025



Permitted Arrangements

Share swaps and deferred payment mechanisms are available to FOCCs when making downstream investments.



Reporting Obligation

If a domestic entity becomes foreign-owned or controlled, it must report the reclassification to the RBI within 30 days using **Form DI**.



What can be done directly, can be done indirectly

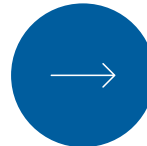


Cross Border Share Swaps

Amendment- Cross Border Swap of Shares

PRIOR TO AMENDMENT

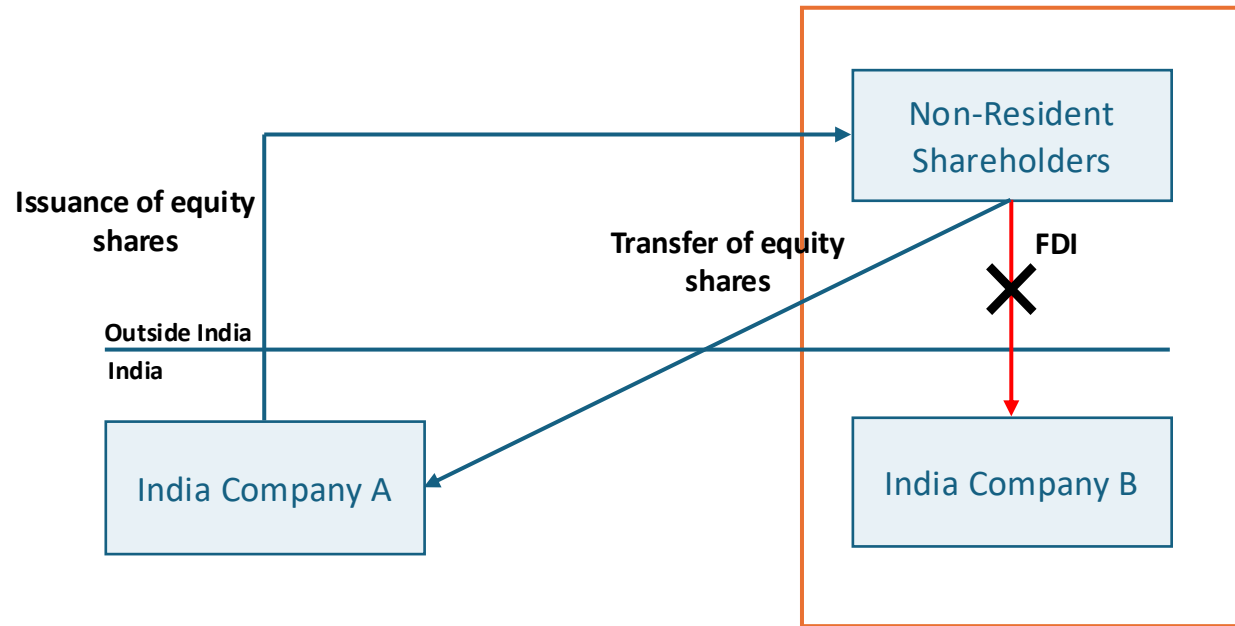
- Indian companies could issue equity instruments to persons resident outside India against the swap of equity instruments of another **Indian company**.
- “Equity instruments” means equity shares, convertible debentures, preference shares and share warrants issued by an Indian company.



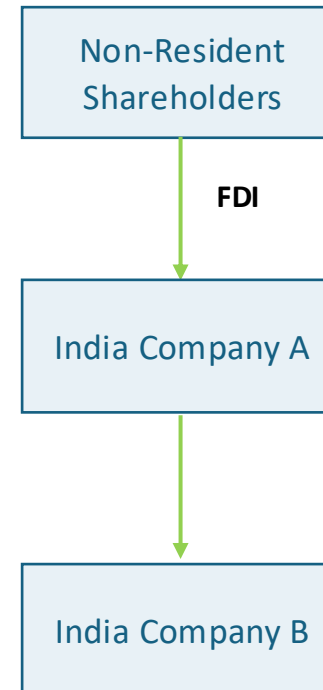
RULE 9A OF NDI RULES, 2019

- Indian companies may issue equity instruments to non-resident shareholders by way of swap of **equity capital of a foreign company**.
- Enables transfer of equity between resident and non-resident shareholders — swapping Indian equity instruments or foreign equity capital.

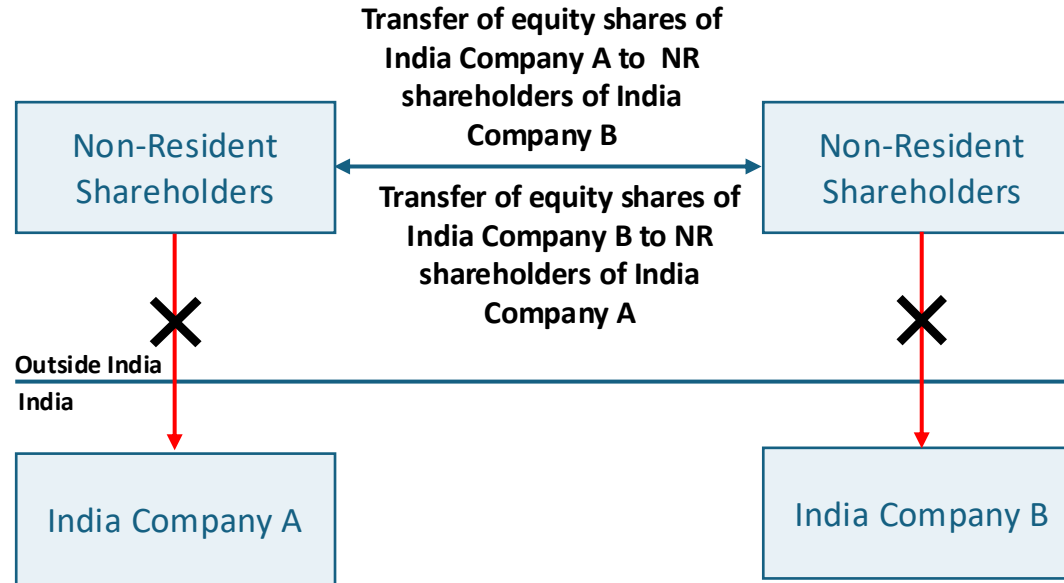
Inbound Swap of Shares by Primary Issuance (FDI-FDI Swap)



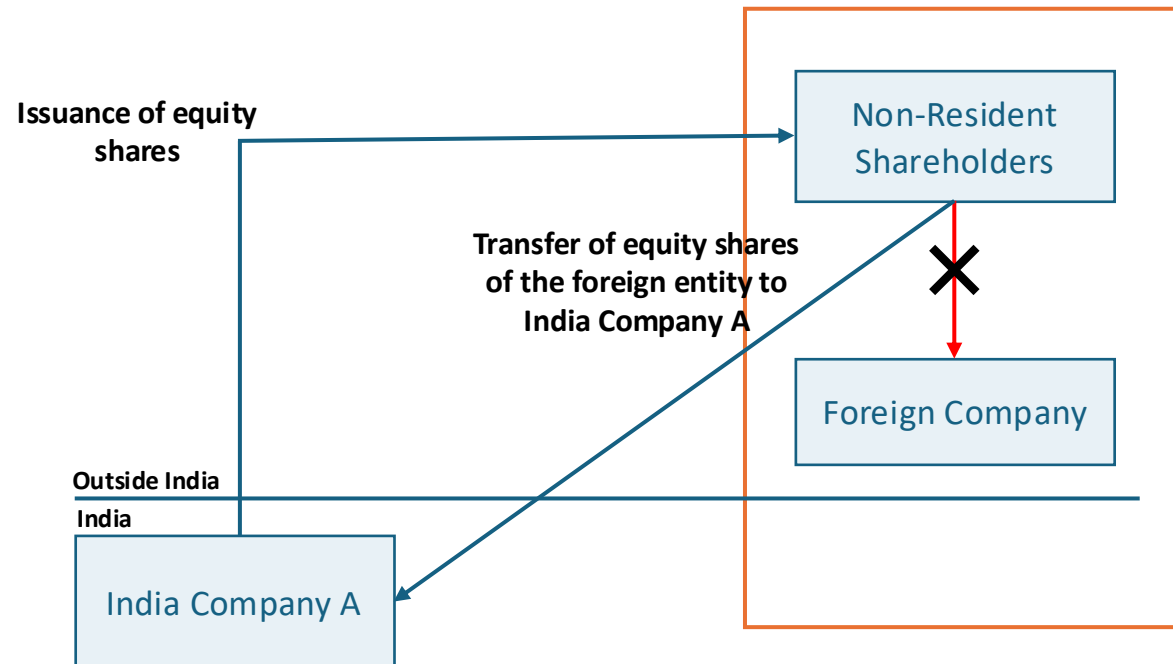
FINAL STRUCTURE



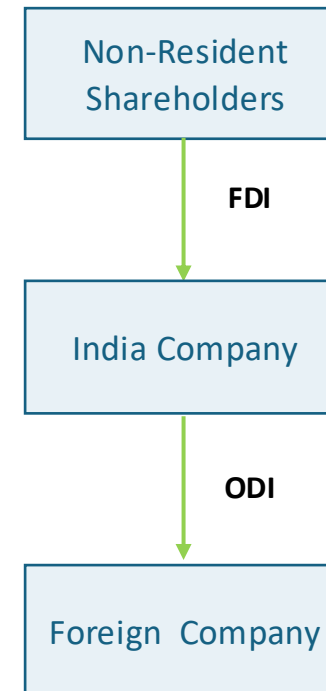
Inbound Share Swap by Secondary Transfer (FDI-FDI Swap)



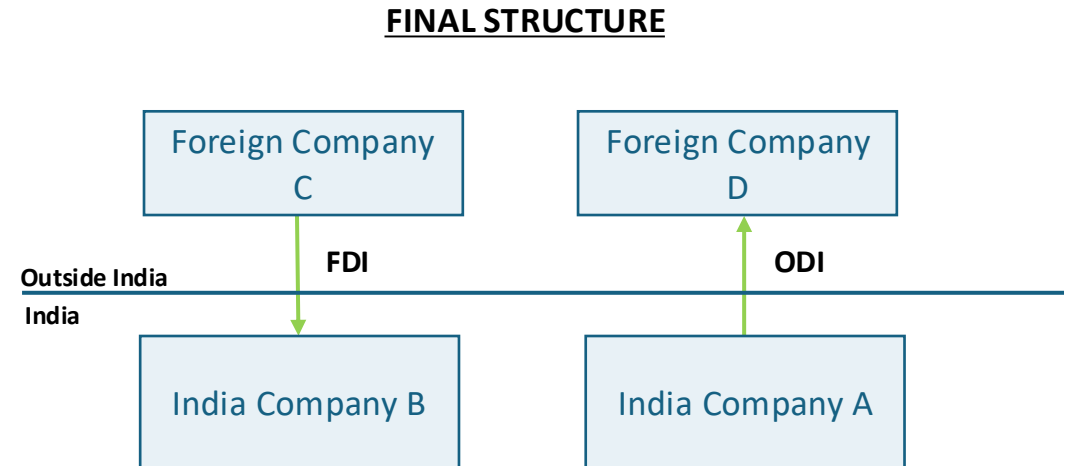
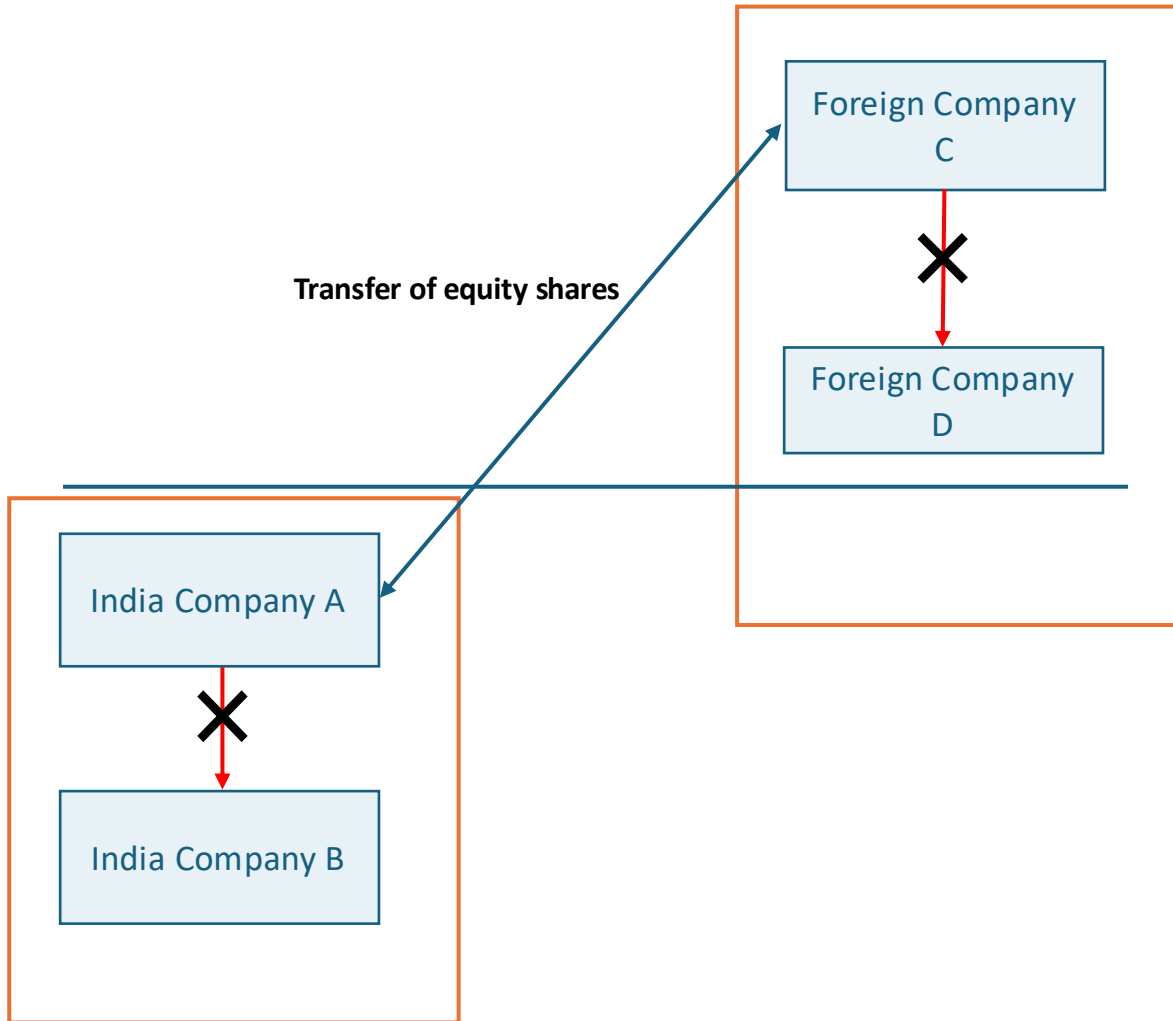
Outbound Share Swap by Primary Issuance (FDI- ODI Swap)



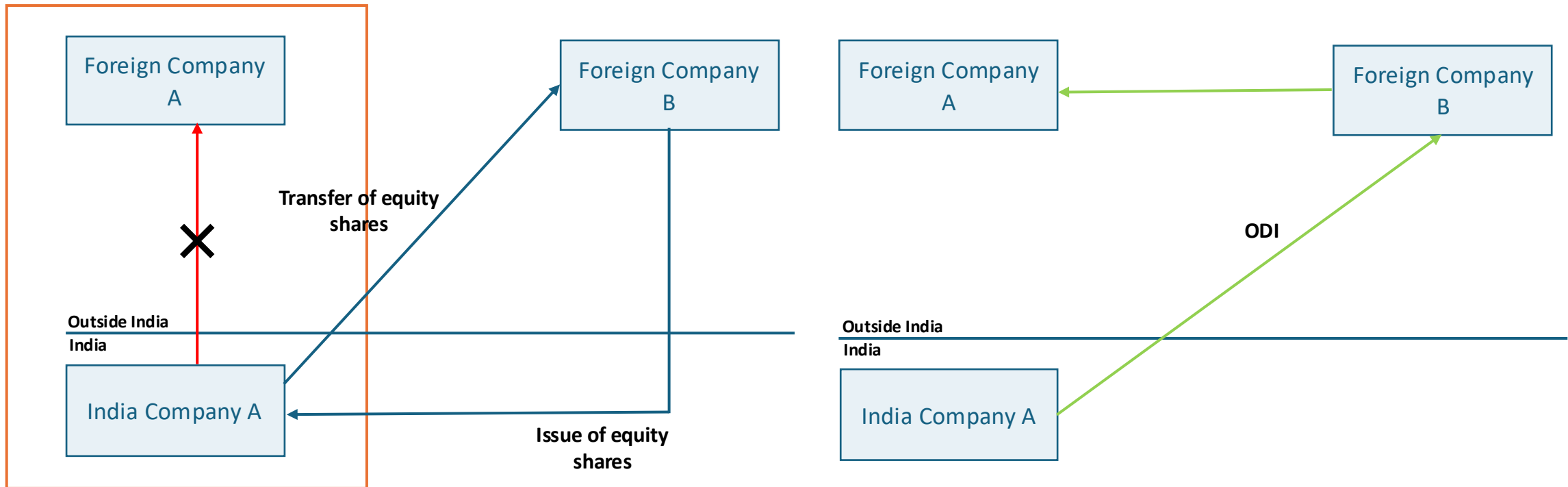
FINAL STRUCTURE



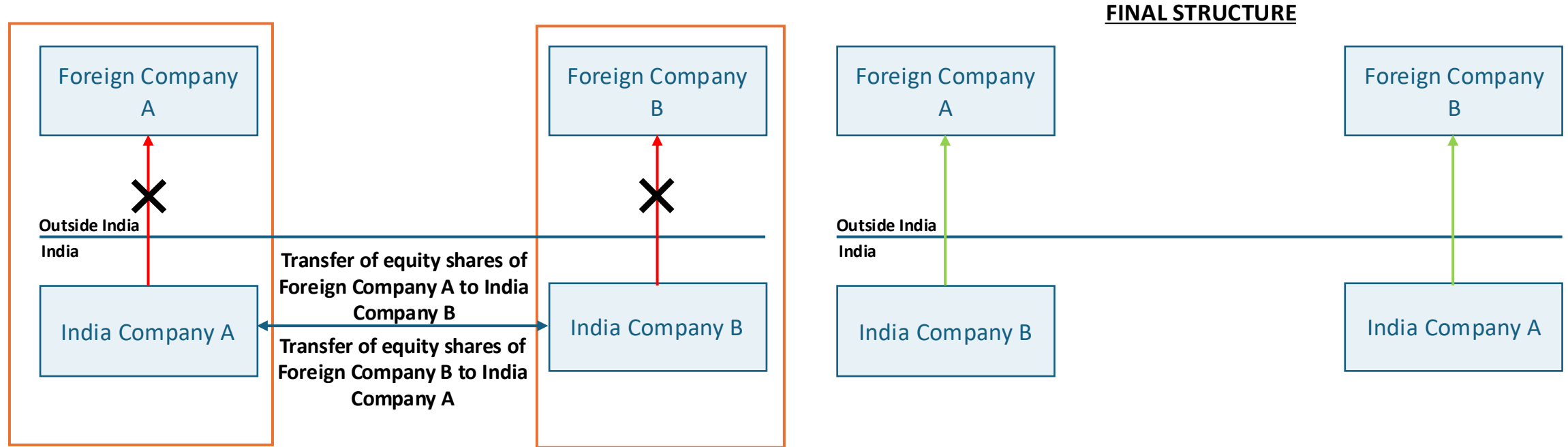
Outbound Share Swap by Secondary Transfer (FDI-ODI Swap)



Outbound Share Swap by Primary Issuance (ODI-ODI Swap)



Outbound Share Swap by Secondary Transfer (ODI-ODI Swap)





Reverse Flipping

Reverse Flipping

NOTABLE REVERSE FLIPS

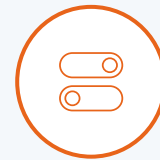


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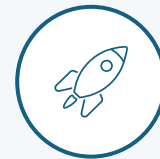
What it is

Companies that first incorporated abroad relocate their headquarters back to their home country, such as India.



How it's structured

Executed through an inbound merger or a share-swap transaction between the entities.



Fast-track route

Fast-track mergers are permitted between a foreign holding company and its Indian WOS.

Reasons for Reverse Flipping



ACCESS TO VENTURE CAPITAL

Tap India's deepening pool of domestic VC and growth-stage capital.



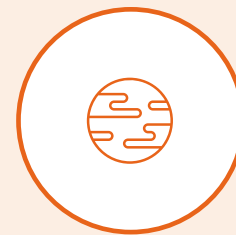
FAVOURABLE TAX REGIME

Lower effective tax burden and less cross-border structuring complexity.



SUPPORTIVE GOVT. POLICIES

Startup India incentives and a more enabling domestic regulatory regime.



MARKET PRESENCE

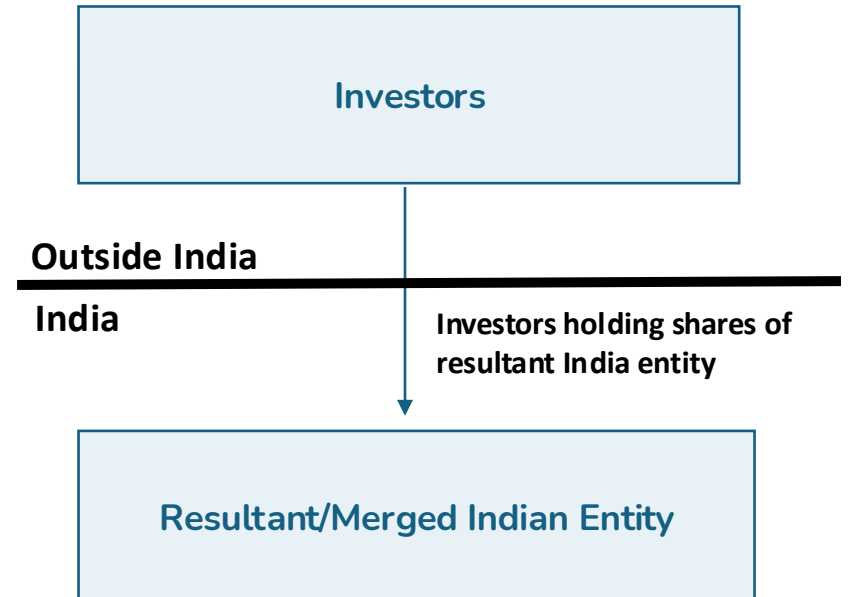
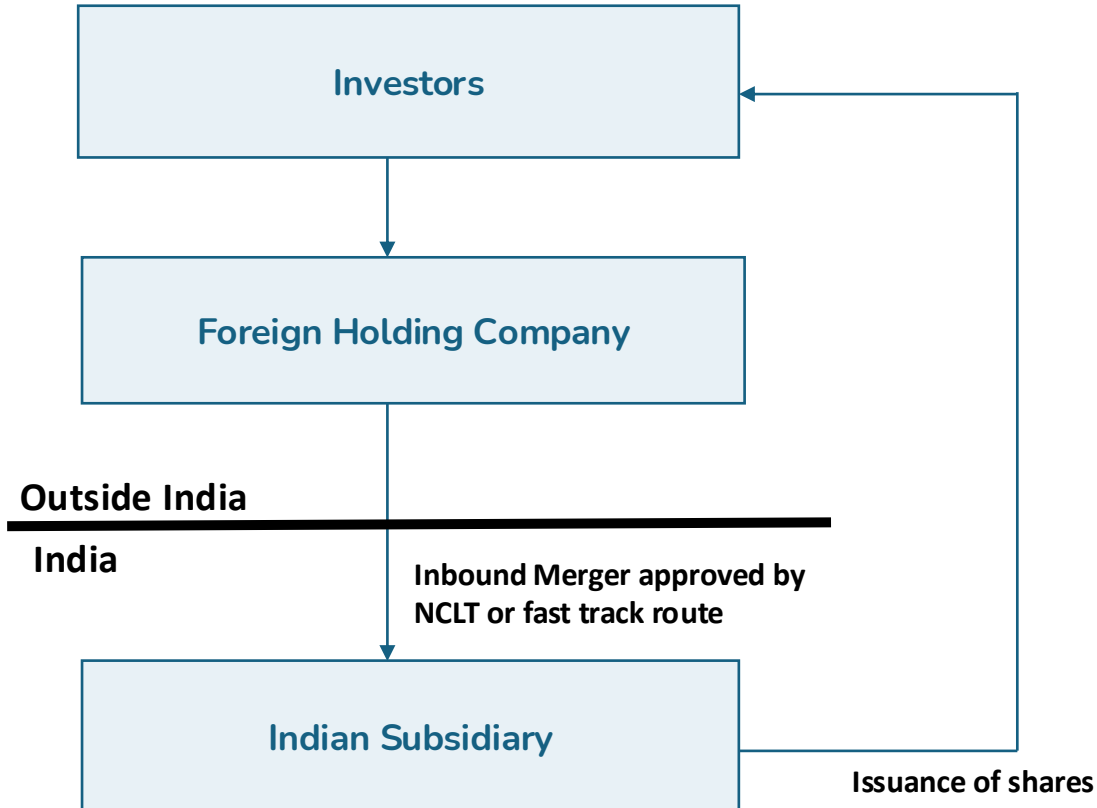
Move closer to a large, fast-growing domestic customer base.



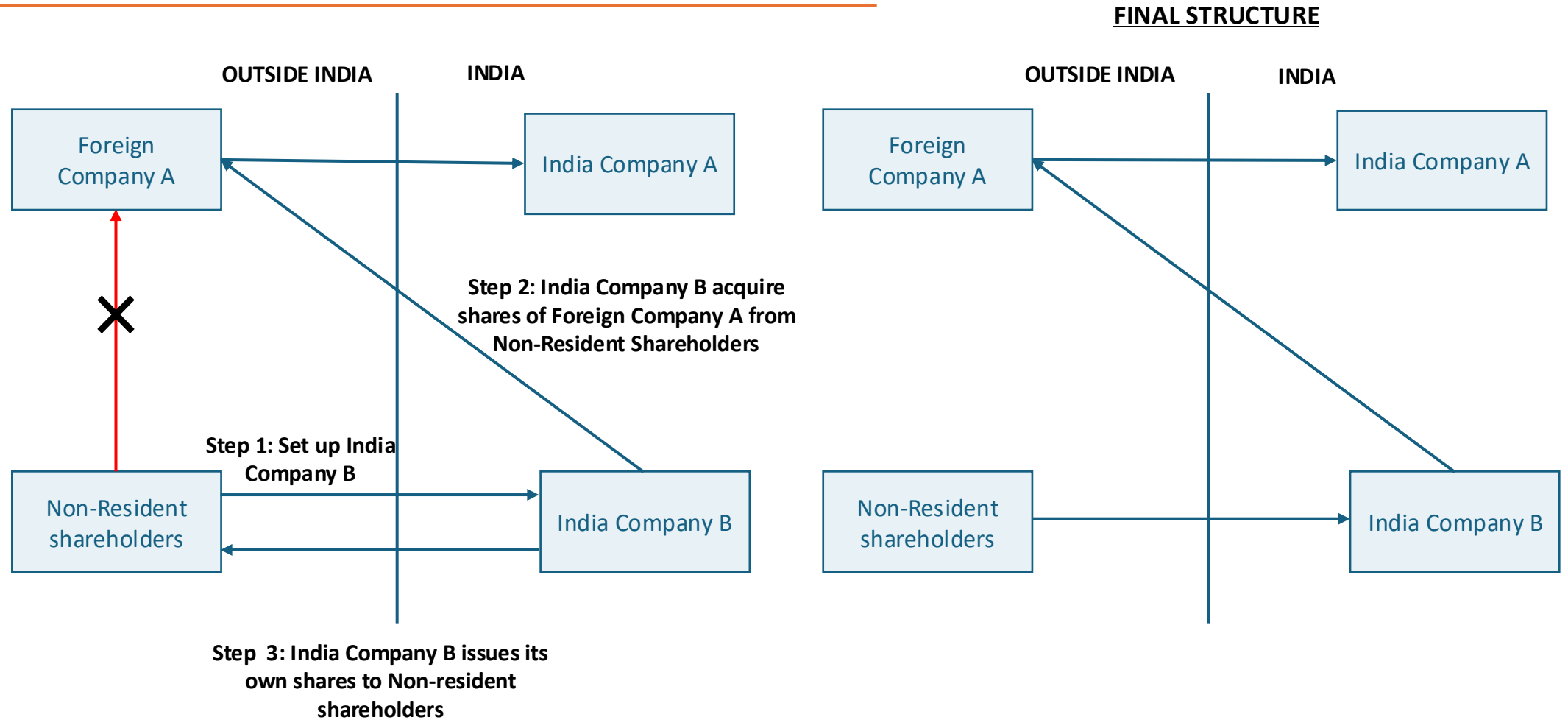
PREPARATION FOR IPO

Position the company for a stronger listing on Indian exchanges.

Reverse Flipping Through Inbound Merger



Reverse Flipping Through Swap of Shares





Pricing Guidelines

Pricing Guidelines



FDI Pricing — by Company Type

Listed Company

Priced per SEBI preferential-allotment guidelines.

Unlisted Company

Internationally accepted pricing methodology on an arm's-length basis. Shares cannot be issued below fair value.



Special Cases

Convertible Instruments

Conversion formula must be determined upfront, at the time of issue.

Subscription to the MoA

May be issued at face value.

Pricing Guidelines

Transfer Pricing — by Direction

Resident → Non-Resident

Price shall not be less than fair value (a floor), per any internationally accepted pricing methodology.

Non-Resident → Resident

Price shall not be more than fair value (a cap), per any internationally accepted pricing methodology.

Special Cases

Swap of Equity Instruments

Valuation by a SEBI-registered Merchant Banker (in India) or Investment Banker (outside India).

Convertible Equity Instruments

Price/conversion formula fixed upfront; conversion price cannot be below the fair value at issuance.

Valuation

- CA/SEBI registered MB/Cost Accountant (as applicable)
- Valuation date must be within permissible validity (i.e., 90 days)

Valuation under FEMA is not just a fairness exercise — it is a regulatory boundary condition.

Valuation & Pricing Guidelines: Key Risk Areas



Discounted issuances: Not permitted under applicable pricing norms.



Stale valuations: Reliance on outdated valuation reports.



Pricing mismatches: Negotiated economics diverging from regulatory pricing requirements.



Preference terms: Ratchets, downside protection and liquidation preferences need careful analysis.



Convertible terms: Clauses that look commercially standard but may raise FEMA concerns.



A deal can be commercially agreed and still be regulatorily mispriced.

Planning for Exit at Entry



Entry shapes exit: Entry terms often determine your flexibility at exit



Assess early: Evaluate exit rights at the investment stage, not later.



Build in the rules: Factor pricing, transfer restrictions and FEMA requirements upfront.



Structure the rights: Review drag/tag rights, put/call options and deferred-consideration structures.



Match the pathway: Align exit mechanisms with the intended route: IPO, strategic sale or buyback.



Many structures look compliant on day one but fail at exit, because exit economics were not structured with FEMA discipline

Compliance Beyond Filings



Ongoing Compliance

- Timely FEMA reporting and regulatory filings
- Maintain approvals, KYC records and transaction documents
- Reconcile filings with statutory records and financials
- Monitor ongoing obligations, including downstream investments



Key Risks

- Delayed or inaccurate filings
- Due-diligence and transaction red flags
- Compounding exposure and regulatory scrutiny
- Delays in future fundraises, exits and restructuring



Regulatory reporting is evidence of compliance. not compliance itself.



Case Studies

Case Study 1: Startup Funding Round

Scenario

Foreign venture capital fund proposes to invest in an Indian SaaS company that also offers embedded payments and lending features

Key FDI Issues

Correct sector classification (pure tech vs regulated fintech); the applicable cap and entry route; permitted instrument (CCPS / CCDs); FEMA pricing; and investor-protection rights vs control

Professional Role

Map the business activity to the right sector; test whether the fintech feature pulls it into a regulated or capped sector; design convertible terms that avoid control and assured-return concerns; and ensure compliant pricing and timely reporting.



Risk is rarely the cap: A single fintech feature can change the entire FDI analysis.

Case Study 2: Downstream Investment by a Foreign-Owned Indian Holdco

Scenario

Indian holding company that already has foreign shareholding makes a further investment into another Indian operating company.

Key FDI Issues

Whether the holdco is foreign-owned or controlled (FOCC); indirect foreign investment; the investee's sector, cap, route and conditions; and pricing and downstream reporting.

Professional Role

Establish ownership and control of the holdco; treat the onward investment as fresh FDI into the investee; verify sector eligibility and conditionalities; and complete downstream-investment filings on time.



Parent-level compliance does not flow downward — every onward investment is a fresh FDI test.

Case Study 3: Family Business Brings in a Strategic Foreign Investor

Scenario

Promoter-led family business raises growth capital from a strategic foreign investor

Key FDI Issues

Control retention vs investor rights; board composition and reserved / affirmative matters; valuation; and exit rights such as put / call, drag and tag

Professional Role

Calibrate governance so investor protections do not amount to control in a sensitive sector; ensure FEMA-compliant pricing; and structure exit rights — especially put options — to be enforceable under FEMA



In sensitive sectors the governance package itself can create the regulatory issue. Negotiate rights with FEMA awareness

Case Study 4: Past Non-Compliance Discovered in Diligence

Scenario

Pre-deal diligence uncovers historic FEMA breaches - late filings, a mispriced allotment and an unreported downstream investment

Key FDI Issues

Remediation route; compounding exposure; impact on the live deal through conditions precedent, representations & warranties and indemnities; and investor comfort.

Professional Role

Quantify the exposure; lead compounding and regularisation; advise on conditions precedent and risk allocation; and build a clean compliance trail going forward.



Old FEMA gaps do not stay buried. They resurface as deal blockers and price chips.

Case Study 5: Cross-Border Internal Group Restructuring

Scenario

A group reorganises across borders — transferring shares between resident and non-resident group entities and inserting a new holding company.

Key FDI Issues

The interplay of FEMA pricing, valuation and transfer pricing; the FEMA approvals and permissions required; downstream effect on existing Indian entities; and the tax and indirect-transfer overlay.

Professional Role

Align FEMA pricing with valuation and transfer-pricing positions; identify the permissions required; test downstream consequences for each Indian entity; and coordinate the tax and reporting workstreams.



Internal restructurings are still ‘transfers’ under FEMA. Pricing, permissions and downstream effects all apply.



Key Take Aways

Boardroom & Promoter Advisory

What clients really ask

- 1 Can we take this investor's money?
- 2 Can we retain control and still grant these rights?
- 3 Can the investor exit at a minimum return?
- 4 Can our Indian holding company invest in another subsidiary?
- 5 Will this affect future fundraising and survive IPO / acquisition diligence?



Strategic shift — move clients from “Can this be filed?” to “Can this structure be defended, implemented, scaled and exited?”

Common Structuring Mistakes

- Assuming 100% FDI means unconditional freedom

- Ignoring downstream investment rules

- Incorrect sector classification

- Overlooking the beneficial ownership chain

- Non-permitted or poorly drafted instruments

- Investor rights that amount to control

- FEMA pricing misaligned with deal valuation

- Delayed filings after allotment or transfer

- Treating RBI reporting as the only checkpoint

- Ignoring sector-regulator conditions

- Not revisiting FDI position when the model changes



Most FDI problems surface not at the first inflow, but at the second-order event.

FDI Does Not Operate in Isolation

FDI considerations intersect with multiple professional domains:



Tax & treaty planning



Companies Act compliance



Valuation & pricing



Audit & financial reporting



M&A due diligence



Startup & PE
documentation



Sector-specific regulatory
approvals

FDI advice in silos is dangerous — members add most value by integrating commercial, tax, legal, and regulatory views.

10 Questions Before Saying Yes to Foreign Investment

1 Who is the investor ultimately?

2 What is the exact business activity of the Indian company?

3 What sector does that activity fall into for FDI purposes?

4 What is the cap and the entry route?

5 Are there sector-specific conditions beyond the cap?

6 Does the proposed instrument qualify as a permitted capital instrument?

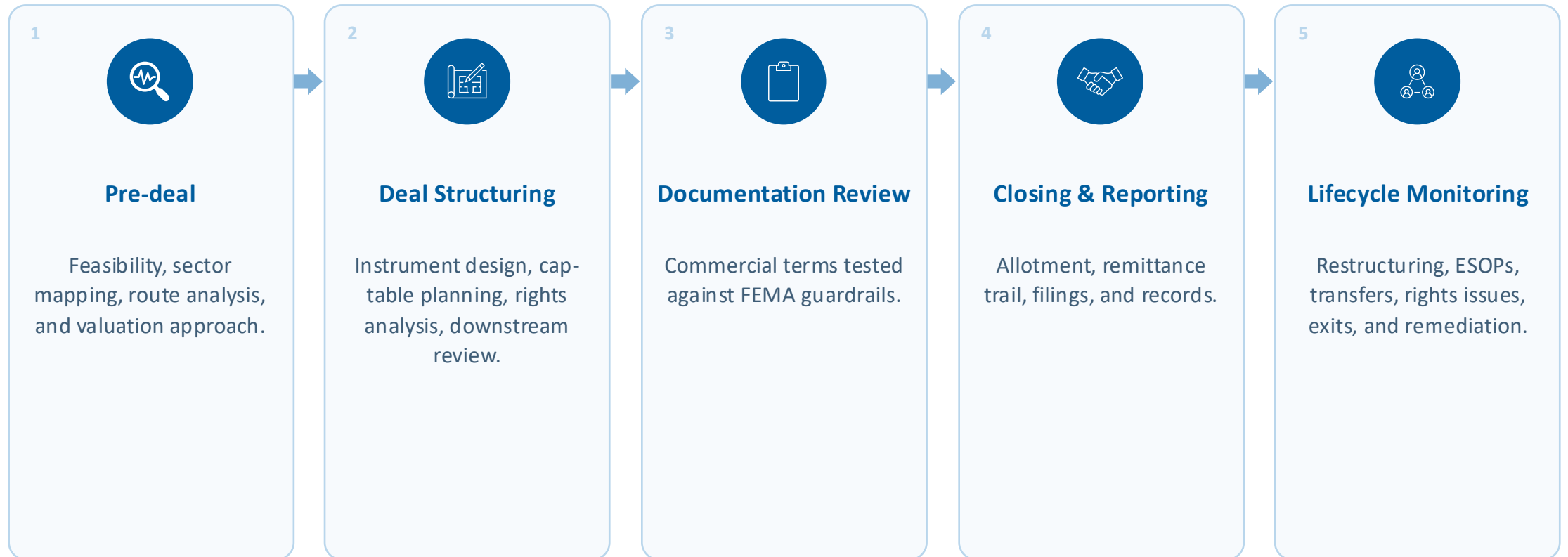
7 Do the pricing and valuation terms comply?

8 Do the governance rights create control concerns?

9 Will this create downstream investment implications?

10 Will the structure remain compliant at exit or future fundraising?

Adding Value Across the Lifecycle



Five Pillars of FEMA Advisory



Eligibility

Can this investor invest in this business?



Structure

Through which entity and instrument?



Control

Do the rights change the regulatory position?



Compliance

Are pricing, reporting and sectoral conditions met?



Exit

Will the structure survive transfer, restructuring or listing?



FDI compliance is not an event at remittance. It is a lifecycle discipline from entry to exit.

Legalogic

Thank You

Questions & Discussion

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