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Foreign Exchange Regulatory Regimes in India

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1. INTRODUCTION:

Indian telecom industry is growing at a great pace and India is expected to become a manufacturing hub for telecom equipment. Indian telecom equipment manufacturing sector is set to become one of the largest sectors globally by 2010. Due to rising demand for a wide range of telecom equipment, particularly in the area of mobile communications, has provided excellent opportunities to domestic and foreign investors in the manufacturing sector. The Indian telecom market is expected to grow three fold by 2012 and market size over US $8 billion. Moreover, the government has set a target of 20 million broadband connections by 2010. Following the well established regulatory framework in post-liberalisation era, Indian telecom industry is becoming a hot bed for international investors. The dynamics of the sector has stirred the global players and hence investments in the sector are also on the rise. The telecom sector has shown robust growth during the past few years. Investors can look to capture the gains of the Indian telecom boom and diversify their operations outside developed economies that are marked by saturated telecom markets and lower GDP growth rates. This necessarily involves the foreign direct investment and therefore is the subject of foreign exchange control and management regimes in India.

ZTE Corporation started its Indian operations during the same time when the foreign exchange regimes were under process of transformation. It was the same time when ZTE established its wholly owned subsidiary in India in 2003 with the aim of manufacturing the state of art telecom equipment to the Indian market and to give perdurable support to customers of Indian market. With the intent of having full fledged manufacturing facility in India, it is inevitable to be abreast with the ever evolving policies of FDI and foreign exchange control regulations of India.

This is an attempt to set out the rationale of the liberalization and simplification of process and procedures for foreign exchange transactions. What has been the philosophy behind India's policies in regard to the external sector? What are the policies and initiatives adopted by India while integrating with globalization of telecommunication sector? What are the policy measures taken for simplification and liberalization of process and procedures for foreign exchange transactions?

This paper seeks to answer the foreign exchange regulatory regimes in India. In particular the foreign exchange management act and regulations which mainly govern and regulate the foreign direct investment.

2. FOREIGN EXCHANGE REGULATIONS IN INDIA:

Constitutional Basis:

Foreign trade is a central subject. The Indian Parliament has the exclusive powers to legislate subject relating to trade and commerce with foreign countries, import & export. The foreign exchange Management Act derives its powers from various entries in the Union list.

Object of the act:

India's foreign exchange control regime was governed by the ***Foreign Exchange Regulation Act, 1973*** **(FERA)** until June 2000. Comprehensive amendments to FERA, especially with respect to foreign investment and foreign trade had been undertaken in order to give effect to the on-going process of economic liberalisations. Significant developments have taken place since 1993 such as substantial increase in our foreign exchange reserves, growth in foreign trade, rationalisation of tariffs, current account convertibility, liberalisation of Indian investments abroad, increased access to external commercial borrowings by Indian corporate and participation of foreign institutional investors in Indian stock markets. Keeping in view the changed environment, the Central Government introduced the Foreign Exchange Management Bill and repealed the Foreign Exchange Regulation Act, 1973 with the aim to consolidate and amend the law relating Foreign Exchange with the objective of facilitating external trade and payments and for promoting orderly development and maintenance of foreign exchange markets in India. The new act is called the ***"Foreign Exchange Management Act, 1999*** **(FEMA)*.*** This act has provided mechanisms in dealing in foreign exchange with a view to facilitate external trade and payments (which includes imports as well as exports). The impetus is on facilitation of export and import and freeing the payments relating to the external trade.

From "Control to Management":

The scheme of FERA provided for obtaining Reserve Bank's permission either special or general, in respect of most of the regulations there under. The general permissions have been granted by Reserve Bank under these provisions in respect of various matters by issuing a large number of notifications from time to time since the Act came into force from 1st January 1974. Special permissions were granted upon the applicants submitting prescribed applications for the purpose. Thus in order to understand the operative part of the regulations one had to refer to the Exchange Control Manual as well as the various notifications issued by RBI and the Central Government.

FEMA has brought about a sea change in this regard and except for section 3, which relates to dealing in foreign exchange, etc. no other provisions of FEMA stipulate obtaining RBI permission. It appears that this is a transition from an era of permissions to regulations. The emphasis of FEMA is on RBI laying down the regulations rather than granting permissions on case to case basis. This transition has also taken away the concept of "Exchange Control" and brought in the phase of "Exchange Management".

The definitive shift in the objectives of the FEMA could be seen in the preamble to the new legislation. The preamble of the Act states that the Act seeks to consolidate and amend the law relating to foreign exchange with a view to-

(a) facilitate external trade and payments;

(b) promote orderly development and maintain the foreign exchange markets

The old act had the objective of regulating dealings in foreign exchange in order to conserve precious foreign exchange.

This changed the legislative framework governing foreign exchange transactions. Accordingly, the FERA which formed the statutory basis for exchange control in India was repealed by the new FEMA with effect from June 2000. The philosophical approach has shifted from that of conservation of foreign exchange to one of facilitating trade and payments as well as developing orderly foreign exchange market.

As far as facilitating external trade is concerned, section 5 of the Act removes restrictions on drawal of foreign exchange for the purpose of current account transactions. As external trade i.e. import/export of goods & services involve transactions on current account, there will be no need for seeking RBI permissions in connections with remittances involving external trade. The need to remove restrictions on current account transactions was necessitated as the country had given notice to the IMF (International Monetary Funds) in August, 1994 that it had attained Article VIII status. This notice meant that no restrictions will be imposed on remittances of foreign exchange on account of current account transactions.

Section 5, however, contains a proviso that the Central Government may, in Public interest and in consultation with the Reserve Bank, impose such reasonable restrictions for current account transactions as may be prescribed. It appears that this is an enabling provision for the Central Government to impose restrictions probably due to foreign exchange crisis in future.

Similarly, section 7 retains controls on exporters.

FERA contained 81 sections (some were deleted in the 1993 amendment of Act) of which 32 sections related to operational part and the rest covered penal provisions, authority and powers of Enforcement Directorate, etc. FEMA contains 49 sections of which 12 sections cover operational part and the rest contravention, penalties, adjudication, appeals, enforcement directorate, etc.

The FERA was replaced by the FEMA as it was an impediment in India’s to go Global. India’s foreign exchange transactions were governed under the FERA until June 2000. This law had been enacted in 1973 when Indian economy was facing a crisis and foreign exchange had become a precious commodity. But by the nineties, FERA had outlived its utility and was in fact, an impediment in India’s effort to go global and compete with other developing countries. Thus it required to repeal the FERA and FEMA 1999 came into force on June 2000. However some of the relevant progresses made, from FERA to FEMA are as follows;

The restrictions on withdrawal of foreign exchange for the purpose of current account transactions, has been removed. However, the central Government may, in public interest in consultation with the Reserve Bank impose such reasonable restrictions for current account transactions as may be prescribed.

FEMA has also by and large removed the restrictions on transactions in foreign exchange on account of trade in goods, services except for retaining certain enabling provisions for the Central Government to impose reasonable restrictions in public interest.

What is foreign Exchange Management Act, 1999 (FEMA)

FEMA which has replace FERA, had become the need of the hour since FERA had become incompatible with the pro-liberalisation policies of the Government of India. FEMA has brought a new management regime of Foreign Exchange consistent with the emerging frame work of the World Trade Organisation (WTO). The enactment of FEMA brought with it Prevention of Money Laundering Act, 2002 (PMLA) which came into effect recently from 1st July, 2005 and the heat of which is yet to be felt as “Enforcement Directorate” would be investigating the cases under PMLA too.

Objective and Extent of FEMA

The objective of the Act is to consolidate and amend the law relating to foreign exchange with the objective of facilitating external trade and payments and for promoting orderly development and maintenance of foreign exchange market in India. The FEM act applies to whole of India, to all branches, offices and agencies outside India owned or controlled by a person resident in India and also to any contravention committed under this act outside India by any person. Therefore this act confers the extra-territorial jurisdiction in respect of offences committed outside India by any person to whom this act applies.

Except with general or special permission of the Reserve Bank of India, no person can:-

- Deal in or transfer any foreign exchange or foreign security to any person not being an authorised person;
- Make any payment to or for the credit of any person resident outside India in any manner;
- Receive otherwise through an authorised person, any payment by order or on behalf of ay person resident outside India in any manner;
- Reasonable restrictions for current account transactions as may be prescribed.

Any person may sell or draw foreign exchange to or from an authorised person for a capital account transaction. The Reserve Bank may, in consultation with the Central Government, specify:-

- Any class or classes of capital account transactions which are permissible;
- The limit up to which foreign exchange shall be admissible for such transactions.

However, the Reserve Bank cannot impose any restriction on the drawing of foreign exchange for payments due on account of amortization of loans or for depreciation of direct investments in the ordinary course of business.

The Reserve Bank can, by regulations, prohibit, restrict or regulate the following:

- Transfer or issue of any foreign security by a person resident in India;
- Transfer or issue of any security by a person resident outside India;
- Transfer or issue of any security or foreign security by any branch, office or agency in India of a person resident outside India;

- Any borrowing or lending in foreign exchange in whatever form or by whatever name called;
- Any borrowing or lending in rupees in whatever form or by whatever name called between a person resident in India and a person resident outside India;
- Deposits between persons resident in India and persons resident outside India;
- Export, import or holding of currency or currency notes;
- Transfer of immovable property outside India, other than a lease not exceeding five years, by a person resident in India;
- Acquisition or transfer of immovable property in India, other than a lease not exceeding five years, by a person resident outside India;
- Giving of a guarantee or surety in respect of any debt, obligation or other liability incurred
    - By a person resident in India and owed to a person resident outside India or
    - By a person resident outside India.

A person, resident in India may hold, own, transfer or invest in foreign currency, foreign security or any immovable property situated outside India if such currency, security or property was acquired, held or owned by such person when he was resident outside India or inherited from a person who was resident outside India. A person resident outside India may hold, own, transfer or invest in Indian currency, security or any immovable property situated in India if such currency, security or property was acquired, held or owned by such person when he was resident in India or inherited from a person who was resident in India.

The Reserve Bank may, by regulation, prohibit, restrict, or regulate establishment in India of a branch, office or other place of business by a person resident outside India, for carrying on any activity relating to such branch, office or other place of business.

Every exporter of goods and services must:

- Furnish to the Reserve Bank or to such other authority a declaration in such form and in such manner as may be specified, containing true and correct material particulars, including the amount representing the full export value or, if the full export value of the goods is not ascertainable at the time of export, the value which the exporter, having regard to the prevailing market conditions, expects to receive on the sale of the goods in a market outside India;
- Furnish to the Reserve Bank such other information as may be required by the Reserve Bank for the purpose of ensuring the realization of the export proceeds by such exporter.

The Reserve Bank may, for the purpose of ensuring that the full export value of the goods or such reduced value of the goods as the Reserve Bank determines, having regard to the prevailing market-conditions, is received without any delay, direct any exporter to comply with such requirements as it deems fit. Where any amount of foreign exchange is due or has accrued to any person resident in India, such person shall take all reasonable steps to realize and repatriate to India such foreign exchange within such period and in such manner as may be specified by the Reserve Bank.

FEMA Rules and Policies:

FEMA vests with the Reserve Bank of India, the sole authority to grant general or special permission for all foreign exchange related activities mentioned above. The Reserve Bank of India's Exchange Control Department, administers foreign Exchange Management Act, 1999 (FEMA). The Act FEMA deals with regulation and management of foreign exchange in the following areas;

- Dealing in foreign exchange
- Holding of foreign exchange
- Current account transactions
- Capital account transactions
- Export of goods and services
- Realisation and repatriation of foreign exchange
- Exemption from realisation and repatriation in certain cases

Contraventions and Penalties under FEMA:

If any person contravenes any provision of this Act, or contravenes any rule, regulation, notification, direction or order issued in exercise of the powers under this Act, or contravenes any condition subject to which an authorization is issued by the Reserve Bank, he shall, upon adjudication, be liable to a penalty up to thrice the sum involved in such contravention where such amount is quantifiable, or up to (Rupees Two Lacs) Rs. 2,00,000=00 where the amount is not quantifiable, and Where such contravention is a continuing one, further penalty which may extend to five thousand rupees for every day after the first day during which the contravention continues. Any Adjudicating Authority adjudging any contravention may, if he thinks fit in addition to any penalty which he may impose for such contravention direct that any currency, security or any other money or property in respect of which the contravention has taken place shall be confiscated to the Central Government and further direct that the foreign exchange holdings, if any, of the persons committing the contraventions or any part thereof, shall be brought back into India or shall be retained outside India in accordance with the directions made in this behalf.
"Property" in respect of which contravention has taken place, shall include deposits in a bank, where the said property is converted into such deposits, Indian currency, where the said property is converted into that currency; and any other property which has resulted out of the conversion of that property. If any person fails to make full payment of the penalty imposed on him within a period of ninety days from the date on which the notice for payment of such penalty is served on him, he shall be liable to civil imprisonment.

Reserve Bank has been empowered to give to the authorized person any direction in regard to making of payment of the doing or desist from doing any act relating to foreign exchange or foreign security and has also been empowered to direct any authorized person to furnish such information in such manner as it deems fit. If any authorized person contravenes any direction or fails to furnish any information as directed by the Reserve Bank he is liable to a penalty up to ten thousand rupees and in the case of continuing contravention with an additional penalty up to two thousand rupees for every day.

Section 16 provides for appointment of Central Government officers as Adjudicating authorities for holding an inquiry for the purpose of imposing any penalty. It also provides for the procedure for taking cognizance by the Adjudicating Authority and confers powers of civil court on the said Authority. Further section 18 provides for preferring of appeal before the Appellate Tribunal against the order made by the adjudicating authority, period for filing the appeal, condonation of delay for sufficient cause and the period for disposal of appeal. An appeal can be filed to the High Court against the decision or order of the Appellate Tribunal on a question of law arising out of such decision or order.

3. <u>REGULATION AND MANAGEMENT OF FOREIGN EXCHANGE</u>:

Section 2 -The Act here provides clarity on several definitions and terms used in the context of foreign exchange. Starting with the identification of the Non-resident Indian and Persons of Indian origin, it defines "foreign exchange" and "foreign security" in sections 2(n) and 2(o) respectively of the Act. It describes at length the foreign exchange facilities and where one can buy foreign exchange in India. FEMA defines an authorized dealer, and addresses the permissible exchange allowed for a business trip, for studies and medical treatment abroad, forex for foreign travel, the use of an international credit card, and remittance facility. Important and relevant definitions are reproduced here in below in annexure in the context of the provisions of the FEMA.

Section 3 prohibits dealings in foreign exchange except through an authorised person. Similarly, without the prior approval of the RBI, no person can make any payment to any person resident outside India in any manner other than that prescribed by it. The Act restricts non-authorised persons from entering into any financial transaction in India as consideration for or in association with acquisition or creation or transfer of a right to acquire any asset outside India.

Section 4 restrains any person resident in India from acquiring, holding, owning, possessing or transferring any foreign exchange, foreign security or any immovable property situated outside India except as specifically provided in the Act.

Section 6 deals with capital account transactions. This section allows a person to draw or sell foreign exchange from or to an authorised person for a capital account transaction. RBI in consultation with the Central Government has issued various regulations on capital account transactions in terms of sub-sect ion (2) and (3) of section 6.

Section 7 covers the export of goods and services. All exporters are required to furnish to the RBI or any other authority, a declaration regarding full export value.

Section 8 puts the responsibility of repatriation on the person resident in India who has any amount of foreign exchange due or accrued in their favour to get the same realised and repatriated to India within the specific period and in the manner specified by the RBI.

The duties and liabilities of the Authorised Dealers have been dealt with in **Sections 10, 11 and 12**. The Act also provides for the contraventions and penalties of this act, rules or regulations of FEM and lays down the provisions for adjudication and appeal. **Sections 13 to 15** cover penalties and enforcement of the orders of the Adjudicating Authority as well as the power to compound contraventions under the Act.

Regulatory provisions related to Current Account Transactions & Capital Account:
Current Account Transactions:
Current Account Transactions as defined in Section 2(j) of FEMA, means a transaction other than a capital account transaction and without prejudice to the generality of the foregoing such transaction includes,

(i) Payments due in connection with foreign trade, other current business, services, and short-term banking and credit facilities in the ordinary course of business,
(ii) Payments due as interest on loans and as net income from investments,
(iii) Remittances for living expenses of parents, spouse and children residing abroad, and
(iv) Expenses in connection with foreign travel, education and medical care of parents, spouse and children;

Provisions to Section 5 of FEMA empowers the Central Government in public interest and in consultation with the Reserve Bank to impose such reasonable restrictions for current account transactions in exercise of the powers conferred and in consultation with the Reserve Bank the Central Government issued *Foreign Exchange Management (Current Account Transactions) Rules 2000 on 3rd May, 2000* in this regard.
In terms of provisions of Section 5 of FEMA, any person may sell or draw foreign exchange to or from an authorised dealer if such sale or withdrawal is a current account transaction.
The proviso to Section 5 empowers Government of India, in public interest and in consultation with the Reserve Bank to impose reasonable restrictions on certain current account transactions. In the light of the rules 3, drawal of exchange for the following transactions is prohibited;

- Travel to Nepal or Bhutan
- Transactions with a person resident in Nepal or Bhutan (unless specifically exempted by Reserve Bank by general or special order).
- Remittance out of lottery winnings
- Remittance of income from racing/riding etc. or any other hobby.
- Remittance for purchase of lottery tickets, banned/proscribed magazines, football pools, sweepstakes, etc.
- Payment of commission on exports made towards equity investment in Joint Ventures/Wholly Owned Subsidiaries abroad of Indian companies.
- Remittance of dividend by any company to which the requirement of dividend balancing is applicable.
- Payment of commission on exports under Rupee State Credit Route. Payment related to "Call Back Services" of telephones.

- Remittance of interest income on funds held in Non-Resident Special Rupee (NRSR) Account scheme.

Prohibition on drawal of foreign exchange:

Rule 3 of Foreign Exchange Management (Current Account Transactions) Rules, 2000 provides that the drawal of foreign exchange by a person is prohibited for the following purposes, namely:

- transactions specified in Schedule III of the notification;
- travel to Nepal and/or Bhutan;
- A transactions to the person resident in Nepal/or Bhutan.

The prohibition on the transaction with a person resident in Nepal or Bhutan may be exempted by the Reserve Bank of India subject to such terms and conditions as it may considered necessary to stipulate by general or special order.

The transactions which are specified in Schedule P and thereby absolutely prohibited are:

- Remittance out of lottery winnings;
- remittance of income from racing/riding etc. or any other hobby;
- remittance for purchase of lottery tickets, banned/prescribed magazines, football pools, sweepstakes etc;
- payment of commission on exports made towards equity investment in joint ventures/wholly owned subsidiaries abroad of Indian companies;
- remittance of dividend by any company to which the requirement of dividend balancing is applicable;
- Payment of commission on exports under Rupee State Credit Route;
- payment related to "Call Back Services" of telephone;
- remittance of interest income on funds held in Non-Resident Special Rupee Scheme Account;

Prior approval of the Government of India: Provides that no person shall draw foreign exchange for the transaction included in Table in Annexure -A without prior approval of the Government of India. The provisions to this rule states that this rule shall not apply where the payment is made out of funds held in Resident Foreign Currency (RFC) Account or Exchange Earners Foreign Currency (EEFC) Account of the remitter.

Prior Approval of Reserve Bank:

There are certain transactions listed in below which cannot be undertaken without the prior approval of the Reserve Bank, these provisions shall not apply where the payment is made out of funds held in Resident Foreign Currency (RFC) Account or Exchange Earners Foreign Currency (EEFC) Account of the remitter.

The transactions for which prior approval of the Reserve Bank is needed are as follows: Remittance by artiste e.g. wrestler, dancer, entertainer etc. (This restriction is not applicable to artistes engaged by tourism related organizations in India like ITDC, State Tourism Development Corporations etc. during special festivals or those artistes engaged by hotels in five star categories, provided the expenditure is met out of EEFC account);

- Release of exchange exceeding US$ 5,000 or its equivalent in one calendar year, for one or more private visits to any country (except Nepal and Bhutan);

- Gift, remittance exceeding US$ 5,000 per beneficiary per annum;
- Donation exceeding US$ 5,000 per annum per beneficiary ;
- Exchange Facilities exceeding US$ 5000 for persons going abroad for employment;
- Exchange Facilities for emigration exceeding US$ 5,000 or amount prescribed by country of emigration;
- Remittance for maintenance of close relatives abroad exceeding US$ 5,000 per year per recipient;
- Release of foreign exchange, exceeding US$ 25,000 to a person, irrespective of period of stay, for business travel, or attending a Conference or specialized training or for maintenance expenses of a patient going abroad for medical treatment or check-up abroad, or for accompanying as attended to a patient going abroad for medical treatment/Check-up;
- Release of exchange for meeting expenses for medical treatment abroad exceeding the estimate from the doctor in India or hospital/doctor abroad;
- Release of exchange for studies abroad exceeding the estimates from the institution abroad or US$ 30,000, whichever is higher;
- Commission to agents abroad for sale of resident flats/commercial plots in India, exceeding 5%of the inward remittance;
- Short term credit to overseas offices of Indian companies;
- Remittance for advertisement on foreign television by a person whose export earnings are less than Rupees 10 Lacs during each of the preceding two years;
- Remittances of royalty and payment of lump-sum fee under the technical. Collaboration agreement which has not been registered with Reserve Bank;
- Remittance exceeding US$ 100,000 for architectural/consultancy services procured from abroad;
- Remittances for use and/or purchase of trade mark/franchises in India. Exchange facilities for transactions.

Exchange facilities for transactions:
Exchange facilitate for transaction in schedule II to the rules may be permitted by authorized dealers provided the applicant has secured the approval from the Ministry Department of Government of India indicated against the transactions. In respect of transactions included in Schedule III where the remittance applied for exceeds the limit, if any, indicated in the schedule or other transactions included in Schedule III for which no limit have been stipulated would require prior approval of Reserve Bank.

Remittances for other current Account transactions
Remittances for all other current transactions which are not specifically prohibited under the rules or which are not included in Schedule II or III may be permitted by authorized dealers without any monetary/percentage ceilings subject to compliance with the provisions of Sub-section (5) of Section 10 of FEMA. Remittances for transactions included in Schedule III' may be permitted by authorized dealers up to

the ceilings prescribed therein. It is further clarified that-

- The existing procedure to be followed by Indian companies for entering into collaboration arrangements with overseas collaborators would continue.
- There would be 'no restriction regarding receipt of advance payment or back to back letter of credit for merchandising trade transactions.
- In terms of Foreign Exchange Management (Borrowing or Lending in Foreign Exchange) Regulations 2000, approval of Reserve Bank would be required for importers availing of Supplier's Credit beyond 180 days and Buyer's Credit irrespective of the period of credit.
- Transactions relating to import of ship stores into bond for supply to Indian/foreign flag vessels, Indian Naval ships, and foreign diplomatic personnel will no more be regulated by Reserve Bank.
- Remittance of surplus freight/passage collections by shipping/airline companies or their agents, remittances by break bulk agents, multimodal transport operators, and remittance of freight pre-paid on inward consolidation of cargo, operating expenses of Indian airline/shipping companies etc. may be permitted by authorized dealers after verification of documentary evidence in support of the remittance.

The Reserve Bank will not prescribe the documentation which should be verified by the authorized dealers while permitting remittances for various transactions, particularly of current account. In this connection attention of authorised dealers is drawn to Subsection (5) of Section 10 of FEMA which provides that an authorised person shall before undertaking any transaction in foreign exchange on behalf of any person require that person to make such a declaration and to give such information as will reasonably satisfy him that the transaction will not involve and is not designed for the purpose of any contravention or evasion of the provisions of FEMA or of any rule, regulation, notification, direction or order issued there under. Authorised dealers are advised to keep on record any information/documentation on the basis of which the transaction was undertaken for verification by the Reserve Bank. The said clause further provides that where the said person (applicant) refuses to comply with any such requirement or makes unsatisfactory compliance therewith, the authorised person shall refuse in writing to undertake the transaction and shall if he has reason to believe that any contravention/ evasion is contemplated by the person, report the matter to Reserve Bank.

Capital Account Transactions:

Capital Account Transactions as defined in section 2 (e) of FEMA means a transaction which alters the assets or liabilities, including contingent liabilities, outside India of persons resident in India or assets or liabilities in India of persons resident outside India, and includes transactions referred to in sub-section (3) of section 6;
The new legislation vides Section 6 deals with capital accounts transactions.

Sub-section (1) of the Section 6 gives a general liberty providing that any person may sell or draw foreign exchange to or from an authorized person for a capital account transaction. The application of this clause is however subject to the provisions of Sub-section (2) of the Section 6 which states that the Reserve Bank may in consultation with the Central Government specify any class or classes of capital account transactions which are permissible and the limit up to which foreign exchange shall be admissible for such transactions.

According to the regulations made under Section 6 (2) of FEMA, investment in India by a person resident outside India in any company or partnership firm or proprietary concern which is engaged in the business of Chit Fund or as a Nidhi Company or in Agricultural or Plantation activities or in Real Estate business (other than development of townships, construction of residential commercial premises, roads or bridges) or construction of farm houses or trading in Transferable Development Rights (TDRs) is prohibited.

Schedule I to the regulations specifies the permissible classes of Capital account transactions of a person resident in India and Schedule II specifies the permissible classes of such transactions by a person resident outside India. The foreign exchange management (Permissible Capital Account Transactions) Regulations, 2000 governs the capital account transactions.

Classification of capital account transactions:

The capital account transactions have been classified into two categories:

Capital Account Transactions of the following types made by persons resident in India:

- Investment by a person resident in India in foreign securities.
- Foreign currency loans rose in India and abroad by a person resident in India.
- Transfer of immovable property outside India by a person resident in India.
- Guarantees issued by a person resident in India in favor of a person resident outside India.
- Export, import and holding of currency/currency notes.
- Loans and overdrafts (borrowings) by a person resident in India from a person resident outside India.
- Maintenance of foreign currency accounts in India and outside India by a person resident in India.
- Taking out of insurance policy by a person resident in India from an insurance company outside India.
- Loans and overdrafts by a person resident in India to a person resident outside India.
- Remittance outside India of capital assets of a person resident in India.
- Sale and purchase of foreign exchange derivatives in India and abroad and commodity derivatives abroad by a person resident in India.

Capital account transactions of the following types made by person resident outside India:

- Investment in India by a person resident outside India, that is to say,
  - Issue of security by a body corporate or an entity in India and investment therein by a person resident outside India; and
  - Investment by way of contribution by a person resident outside India

to the capital of a firm or a proprietorship concern or an association of persons in India.

- Acquisition and transfer of immovable property in India by a person resident outside India.
- Guarantee by a person resident outside India in favour of, or on behalf of, a person resident in India.
- Import and export of currency/currency notes into/from India by a person resident outside India.
- Deposits between a person resident in India and a person resident outside India. .
- Foreign currency accounts in India of a person resident outside India.
- Remittance outside India of capital assets in India of a person resident outside India.

Capital account transactions on which restrictions cannot be imposed. There are two types of drawing foreign exchange, they are:

- for amortization of loan;
- for depreciation of direct investments in ordinary course of business.

Restrictions cannot be imposed when drawal is for the purpose of repayments of loan instalments.

Earlier permission relating to capital account transaction:

Under the provisions of FERA no person could make any capital account transactions except with the previous general or special permission of the Reserve Bank.

Prohibitions on capital account transactions in the new legislation

A person resident outside India is prohibited from making investment in India in any form in any company or partnership firm or proprietary concern or any entity, whether in corporate or not, which is engaged or proposes to engage in:

- in the business of chit fund;
    - a Nidhi Company;
    - agricultural or plantation activities;
- real estate business (the term shall not include development of townships, construction of residential or commercial premises, roads or bridges) or construction of farm houses; or
- Trading in Transferable Development Rights (TDRs).The term Transferable Development Rights has been explained under the head 'Meaning of terms'.

Capital Account convertibility:

Capital Account Convertibility refers to the freedom to convert local financial assets into foreign financial assets and vice versa at market determined rates of exchange. It is associated with changes of ownership in foreign/domestic financial assets and liabilities and embodies the creation and liquidation of claims on, or by, the rest of the world.

Convertibility is an International Monetary Fund clause that all the member countries must adhere to in order to work towards the common goals of the organization. However CONVERTIBILITY per se can be looked into from various perspectives and incorporated accordingly by the member nations. An economy can choose to be (a) partially convertible on CURRENT ACCOUNT, (b) partially convertible on CAPITAL ACCOUNT, (c) fully convertible on current account and (d) fully convertible on capital account.

Though the rupee had become fully convertible on current account as early as 1991, the RBI has been adopting a cautious approach towards full float of the rupee. While there has been a substantial relaxation of foreign exchange controls during the last 10 years, the current account convertibility since 1994 means that both resident Indians and corporate have easy access to foreign exchange for a variety of reasons. They are allowed to receive and make payments in foreign currencies on trade account.

Repatriation of Investment Capital and Profits Earned in India:

All foreign investments are freely repatriable, subject to sectoral policies and except for cases where NRIs choose to invest specifically under non-repatriable schemes. Dividends declared on foreign investments can be remitted freely through an Authorized Dealer.

Non-residents can sell shares on stock exchange without prior approval of RBI and repatriate through a bank the sale proceeds if they hold the shares on repatriation basis and if they have necessary NOC/tax clearance certificates issued by Income tax authorities.

For sale of shares through private arrangements, Regional offices of RBI grant permission for recognized units of foreign equity in Indian company in terms of guidelines indicated in Regulation 10.B of Notification No FEMA.20/2000 RB dated May 2000. The sale price of shares on recognized units is to be determined in accordance with the guidelines prescribed under regulation 10B(2) of the above notification.

Profits, dividends, etc, (which are remittances classified as current account transactions) can be freely repatriated.

Acquisition of Immovable Property by Non-Resident:

A person resident outside India, who has been permitted by Reserve Bank of India to establish a branch, or a office, or place of business in India (excluding a Liaison Office), has general permission of Reserve Bank of India to acquire immovable property in India, which is necessary for, or incidental to, the activity. However, in such cases a declaration, in prescribed form (IPI) is required to be filed with Reserve Bank, within 90 days of the acquisition of immovable property.

Foreign nationals of non-Indian origin who have acquired immovable property in India with specific approval of Reserve Bank of India can not transfer such property without prior permission from the Reserve Bank of India. It is governed by *Foreign Exchange Management (Acquisition and transfer of Immovable property in India) Regulations 2000.*

Acquisition of Immovable Property by Non-resident incidental to its activities in India:

As per FEMA *(Acquisition and transfer of Immovable property in India) Regulations 2000,* the automatic route of RBI for investment from person resident outside India is not available for agriculture (including plantation). However, if the FDI company establishes any business activity in India subject to FDI route/guidelines, the same has to be treated as a resident entity under FEMA and as such it would have the same freedom as a resident entity for purchase of immovable property in India for purpose of carrying out business activity incidental to its business activity which is permitted under FEMA Regulations as Regulation 5 of FEMA regulations, 2000.

4. <u>FOREIGN DIRECT INVESTMENT POLICY AND TELECOM SECTOR</u>:

India's recently liberalised FDI policy (2005) allows up to a 100% FDI stake in ventures. Industrial policy reforms have substantially reduced industrial requirements, removed restrictions on expansion and facilitated easy access to foreign technology and foreign direct investments. The upward moving growth curve of telecom sector owes much of the credit to a booming economy and liberalized FDI regime.

Intent and Objective:

'Investment' is usually understood as financial contribution to the equity capital of an enterprise or purchase of shares in the enterprise. 'Foreign investment' is investment in an enterprise by a Non-Resident irrespective of whether this involves new equity capital or re-investment of earnings. Foreign investment is of two kinds- (i) Foreign Direct Investment (FDI) and (ii) Foreign Portfolio Investment.

FDI is a category of cross border investment made by a resident in one economy (the direct investor) with the objective of establishing a 'lasting interest' in an enterprise (the direct investment enterprise) i.e. resident in an economy other than that of the direct investor. The motivation of the direct investor is a strategic long term relationship with the direct investments enterprise to ensure the significant degree of influence by the direct investor in the management of the direct investment enterprise. In India the 'lasting interest' is not evinced by any minimum holding of percentage of equity capital/shares/voting rights in the investment enterprise. Direct investment allows the direct investor to gain to the access of direct investment enterprise which it might otherwise to be unable to do. The objectives of direct investment are different from those of portfolio investment whereby investors do not generally expect to influence the management of the enterprise.

It is the policy of the Government of India to attract and promote productive FDI from non-residents in activities which significantly contribute to industrialization and socio-economic development. FDI is encouraged in enterprises to significantly expand employment and livelihood opportunities, enhance economic value of products, and promote welfare of consumers, increase exports and/or transfer technologies in all economic activities. FDI supplements the domestic capital and technology.

The Legal Basis:

Foreign Direct Investment by non-resident in resident entities through transfer or issue of security to person resident outside India is a 'capital account transaction' and Government of India and Reserve Bank of India regulate this under the 'Foreign Exchange Management Act, 1999' (FEMA) and its various regulations. Keeping in view current and ongoing requirements, the Government notifies from time to time with new regulation; amends/changes in existing sector policy/sector equity cap through order/allied rules, press notes, etc. The regulatory framework over a period of time thus consists of Acts, regulations, Press Notes, Press releases and clarifications. These press notes have sunset clause of six months and a Press note on FDI Regulatory framework is issued every six months which is incorporated and reflected with all changes in regulations during the last intervening period of six months.

Entry Options for FDI:

Given an opportunity for the inflow of FDI, foreign company planning to set up business operations in India has the following options:-

i) By incorporating a company under the companies act, 1956 through *Joint ventures or wholly own subsidiaries*. Foreign equity in such Indian companies can be up to 100% depending on the requirements of the investor, subject to any equity caps prescribed in respect of the area of activities under the foreign direct investment (FDI) policy.

ii) As a foreign company through *Liaison Office/Representative Office, Project office, Branch office.* Such offices can undertake activities permitted under the ***Foreign Exchange Management (Establishment in India of Branch Office of other place of Business) Regulations, 2000.***

Foreign investment is freely permitted in almost all sectors. Under foreign direct investments (FDI) scheme, investments can be made by non-residents in the shares/convertible debentures of an Indian company, under two routes; Automatic Route and Government Route. Under the Automatic route, the foreign investor or the Indian company does not require any approval from the Reserve Bank or Government of India for the investment. Under the Government Route, prior approval of the Government of India, Ministry of finance, foreign investment promotion board (FIPB) is required.

Foreign investment shall include all types of foreign investments i.e. FDI, investment by FIIs, NRIs, ADRs, GDRs, Foreign Currency Convertible Bonds (FCCB) and fully, mandatory & compulsorily convertible preference shares/debentures, regardless of whether the said investments have been made under Schedule 1, 2, 3 and 6 of FEMA (Transfer or Issue of Security by Persons Resident Outside India) Regulations.

FDI Regulatory Framework in Telecommunications sector:

Investment policy in telecommunications sector permits 100% FDI cap/equity in:

- Manufacturing of telecom equipment;
- Internet services (ISP not providing international gateways);
- Infrastructure providers (category I-Providing dark fibre, right of way, duct space, tower)
- Electronic-mail services;
- Voice mail services
- Call centres for IT enabled services

The details are provided herewith because the nature of business of ZTE is similar as described hereinabove. The FDI cap/equity is permitted through automatic route up to 49% and beyond 49% subject to the approval of Foreign Investment Promotion Board (FIPB). This is subject to the condition that such companies shall divest 26% of their equity in favour of Indian Public in 5 years, if these companies are listed in other parts of the world. Depending upon the sector specific requirements, this is also subject to licensing and security requirements where required.

Calculation of total foreign investment i.e. direct & indirect foreign investment in Indian Companies:

Investment in Indian companies can be made both by non-resident as well as resident Indian entities. Any non-resident investment in an Indian company is direct foreign investment. Investment by resident Indian entities could again comprise of both resident and non-resident investment. Thus, such an Indian company would have indirect foreign investment if the Indian investing company has foreign investment in it. The indirect investment can also be a cascading investment i.e. through multi-layered structure.

For the purpose of computation of indirect Foreign investment, Foreign Investment in Indian company shall include all types of foreign investments i.e. FDI; investment by FIIs(holding as on March 31); NRIs; ADRs; GDRs; Foreign Currency Convertible Bonds (FCCB); fully, compulsorily and mandatory convertible preference shares and fully, compulsorily and mandatory convertible Debentures regardless of whether the said investments have been made under Schedule 1, 2, 3 and 6 of FEMA (Transfer or Issue of Security by Persons Resident Outside India) Regulations.

(i) **Counting the Direct Foreign Investment**: All investment directly by a non-resident entity into the Indian company would be counted towards foreign investment.

(ii) **Counting of indirect foreign Investment:**

(a) The foreign investment through the investing Indian company would not be considered for calculation of the indirect foreign investment in case of Indian companies which are 'owned **and** controlled' by resident Indian citizens and/or Indian Companies which are owned and controlled by resident Indian citizens .

(b)For cases where condition (a) above is not satisfied or if the investing company is owned **or** controlled by 'non resident entities', the entire investment by the investing company into the subject Indian Company would be considered as indirect foreign investment,

Provided that, as an exception, the indirect foreign investment in only the 100% owned subsidiaries of operating-cum-investing/investing companies, will be limited to the foreign investment in the operating-cum-investing/ investing company. This exception is made since the downstream investment of a 100% owned subsidiary of the holding company is akin to investment made by the holding company and the downstream investment should be a mirror image of the holding company. This exception, however, is strictly for those cases where the entire capital of the downstream subsidy is owned by the holding company.

(iii) The total foreign investment would be the sum total of direct and indirect foreign investment.

(iv) The above methodology of calculation would apply at every stage of investment in Indian Companies and thus to each and every Indian Company.

(v) The full details about the foreign investment including ownership details etc. in Indian company(s) and information about the control of the company(s) would be furnished by the Company(s) to the Government of India at the time of seeking approval.

(vi) In any sector/activity, where Government approval is required for foreign investment and in cases where there are any *inter-se* agreements between/amongst share-holders which have an effect on the appointment of the Board of Directors or on the exercise of voting rights or of creating voting rights disproportionate to shareholding or any incidental matter thereof, such agreements will have to be informed to the approving authority. The approving authority will consider such *inter-se* agreements for determining ownership and control when considering the case for granting approval for foreign investment.

Investment Incentives

Further it is interestingly noted considering the business of ZTE in India as Wholly owned subsidiary there are couple of investment incentives to Promote Telecom Equipments Manufacturing like:

(i) customs duty on ITA-I (Information technology Agreement) product reduced to zero with effective from 01.03.2005
(ii) 4 per cent additional duty on import of ITA products to countervail the state level taxes.
(iii) No industrial license for manufacturing telecom equipment. Simple Industrial Entrepreneurs Memorandum (IEM) has to be filed with SIA.
(iv) 100 percent foreign direct investment (FDI) through automatic route.
(v) Fully repatriable dividend income and capital invested
(vi) Payment of technical know-how fee of up to US$ 2 million and royalty up to 5 per cent on domestic sales and 8 per cent on export sales, net of taxes, through automatic route.
(vii) Imposition of additional import duty, at the rate not exceeding 4 per cent ad-valorem, to countervail sales tax, value added tax, local taxes and other charges leviable on like goods on their sale or purchase or transportation in India.
(viii) Promotion of telecom products in specific SEZ's (Special Economic Zones).
(ix) Modifications of Electronic Hardware Technology Park (EHTP)/Special Economic Zones (SEZs) scheme to allow 100 per cent sales in the Domestic Tariff Area for the purpose of meeting export obligations.
(x) Import of all capital goods for manufacturing telecom equipments does not require any license.

CONCLUSION:

As a part of the on going process of economic liberalization relating to foreign investments, competing economies and foreign trade in India and as a measure for closer interaction with this foreign exchange regimes in India plays significant role in foreign exchange management. More specifically, telecom sector in India presents a host of opportunities for growth avenues for telecom equipment manufacturing companies like ZTE. Against the background of provisions of FEMA, ZTE has pool of opportunities to explore in manufacturing activities through wholly owned subsidiary “ZTE India”. Under the permissible activities ZTE India can export/import goods, render professional or consultancy services can carry out research work, in which parent company-ZTE is engaged, render technical support to the products supplied by parent/group companies in India.

India’s target for increasing rural tele-density/telephony offers major investment opportunities and boosts the demand for telecom services, equipment, internet services and other values added services; thereby, offering great market for telecom players. Recent auction for the spectrum for 3G is also major growth driver in telecom sector. On account of rapidly growing subscriber base “Managed Services” is another segment where ZTE can focus on infrastructure and network management operations.

Needless, to say that increasingly and ever liberalizing foreign exchange regulatory regimes will be backbone and visionary for the acceleration of domestic economic reforms of India in the process of economic and financial globalization.

ANNEXURE A

Purpose of Remittance	Whose approval is required
Cultural Tours	Ministry of Human Resources Developments (Department of Education and Culture) Ministry of Finance, (Department of Economic Affairs)
Advertisement abroad by any PSU/State And Central Government Department	Ministry of Finance, (Department of Economic Affairs).
Remittance of freight of vessel charted by a PSU (Chartering Wing)	Ministry of Surface Transport
Payment of import by a Government Department (Chartering Wing) or a PSU on *C.I.F* basis *(i.e.* other than *F.O.B* and *F.A.S* basis)	Ministry of Surface Transport
Multi-modal transport operators making remittance to their agents abroad	Registration Certificate from the Director General of Shipping.
Remittance of hiring charges of transponders	Ministry of Finance, (Department of Economic
	Affairs)
Remittance of container detention charges exceeding the rate prescribed by Director General of Shipping	Ministry of Surface Transport (Director General of Shipping)
Remittances under technical collaboration agreements where payment of royalty exceeds 5%on local sales and 8% on exports and lump-sum payment exceeds US$ 2 million	Ministry of Industry and Commerce.
Remittance of prize money/ sponsorship of sports activity abroad by person other than International/ National/State level sports bodies, if the amount involved exceeds US $100000	Ministry of Human Resource Development (Department of Youth Affairs and Sports)
Payment for securing Insurance	Ministry of Finance, (Insurance Division)
for health from a company abroad	
Remittance for membership of P & I Club	Ministry of Finance, (Insurance Division)

GLOSSARY OF KEY TERMS AS DEFINED IN FEMA

Authorised Person means an authorised dealer, money changer, off-shore banking unit or any other person for the time being authorised under sub-section (1) of section 10 to deal in foreign exchange or foreign securities;
Capital Account Transactions means a transactions which alters the assets or liabilities, including contingent liabilities, outside India of persons resident in India or assets or liabilities in India of persons resident outside India, and includes transactions referred to in sub-section (3) of section 6;
Currency includes all currency notes, postal notes, postal orders, money orders, cheques, drafts, travellers' cheques, letter of credit, bill of exchange and promissory notes, credit cards or such other similar instruments, as may be notified by the Reserve Bank;
Current Account Transactions means a transaction other than a capital account transaction and without prejudice to the generality of the foregoing such transaction includes,

- (v) Payments due in connection with foreign trade, other current business, services, and short-term banking and credit facilities in the ordinary course of business,
- (vi) Payments due as interest on loans and as net income from investments,
- (vii) Remittances for living expenses of parents, spouse and children residing abroad, and
- (viii) Expenses in connection with foreign travel, education and medical care of parents, spouse and children;

Drawal means drawal of foreign exchange from an authorized person and includes opening of Letter of Credit or use of International Debit Card or A TM card or any other thing by whatever name called which has the effect of creating foreign exchange liability;
Foreign currency means any currency other than Indian currency;
Foreign Exchange means foreign currency and includes

- (i) deposits, credits and balances payable in any foreign currency,
- (ii) drafts, travellers cheques, letters, letters of credit or bill of exchange, expressed or drawn in Indian currency but payable in any foreign currency,
- (iii) Drafts, traveller's cheques, letter of credit or bills of exchange drawn by banks, institutions or persons outside India, but payable in Indian currency;

Foreign Security means any security, in the form of shares, stocks, bonds, debentures or any other instrument denominated or expressed in foreign currency and includes securities expressed in foreign currency, but where redemption or any form of return such as interest or dividends is payable in Indian currency;
Person includes-

- (i) an individual
- (ii) a Hindu undivided family

(iii) a company
(iv) a firm
(v) an association of persons or a body of individuals, whether incorporated or not,
(vi) every artificial person, not falling within any of the preceding sub-clauses and
(vii) any agency, office or branch owned or controlled by such persons;

Persons resident in India means –

(i) a person residing in India for more than one hundred and eighty two days during the course of the preceding financial year but does not include
  A. a person who has gone out of India or who stays outside India, in either case-
    a) for or on taking up employment outside India or
    b) for carrying on outside India a business or vocation outside India, or
    c) for any other purpose, in such circumstances as would indicate his intention to stay outside India for an uncertain period;
  B. a person who has come to or stays in India, in either case, otherwise than-
    a) for or taking up employment in India, or
    b) for carrying on in India a business or vocation in India, or
    c) for any other purpose, in such circumstances as would indicate his intention to stay in India for an uncertain period;

(ii) any person or body corporate registered or incorporated in India,
(iii) an office, branch or agency, in India owned or controlled by a person resident outside India,
(iv) an office, branch or agency, in India owned or controlled by a person resident in India,

Person resident outside India means a person who is not resident in India;

Security means shares, stocks, bonds and debentures, Government securities, savings certificates to which the Government savings certificates act, 1959 (46 of 1959) applies, deposit receipts in respect of deposits of securities and units of the Unit Trust of India established under sub-section (1) of section 3 of the Unit Trust of India act, 1963 (52 of 1963) or any mutual fund and includes certificates of title to securities, but does not include bills of exchange or promissory notes other than Government promissory notes or any other instruments which may be notified by the Reserve Bank as security for the purposes of this Act;

Service means service of any description which is made available to potential users and includes the provision of facilities in connection with banking, financing, insurance, medical assistance, legal assistance, chit fund, real estate, transport, processing, supply of electrical or other energy, boarding or lodging or both, entertainment, amusement or the purveying of news or other information, but does not include the rendering of any service free of charge or under a contract of personal service;

Transfer includes sale, purchase, exchange, mortgage, pledge, gift, loan or any other form of transfer of right, title, possession or lien.

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