RESTRICTIONS & PROHIBITIONS ON FOREIGN INVESTMENTS

by

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1.] A Brief Background:

Investments in India are regulated under the broader prescriptions of Foreign Exchange Management Act, 1999 which is considered as the parent legislation. Besides dealing with all kinds of transactions in foreign exchange, FEMA also prescribes restrictions & prohibitions on current account transactions.[1] The Act prescribes transactions for which withdrawal of foreign exchange is prohibited,[2] transaction which require prior approval of the government[3] and also transactions that require approval of RBI before commencement.[4] Additionally, payment of commission on exports made towards equity investments in joint ventures or wholly owned subsidiaries of Indian companies abroad is also prohibited. There are many other outward remittances of money that requires prior approval of Reserve Bank of India.[5] There is also a general prohibition in FEMA that no person resident in India shall acquire, hold, own, possess or transfer any foreign exchange, foreign security or any immovable property situated outside India.[6] Apart from the recognized authorized persons under the provisions of FEMA, 1999, it has been stated that no person shall deal in foreign exchange in any manner whatsoever.[7]

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Under TISPROI Regulations, it has been clearly outlined that 'save as otherwise provided in the Act, or rules or regulations made thereunder, no person resident outside India shall make investment in India'[8]; and that 'save as otherwise provided in the Act, rules or regulations made thereunder, an Indian entity or an

[1] Section 2(j) of FEMA, 1999
[2] Schedule I of FEMA, 1999
[3] Schedule II of FEMA, 1999
[4] Schedule III of FEMA, 1999
[5] See for example Sections 11C.1, 11C.2, Reserve Bank of India, Exchange Control Manual
[6] Section 4 of FEMA, 1999
[7] Section 3 of FEMA, 1999
[8] Regulation 3 of TISPROI Regulations, 2017

investment vehicle, or a venture capital fund, or a firm or an association of persons or a proprietary concern shall not receive any investment in India from a person resident outside India or record such investment in its books'[9]. It has also been provided that 'unless otherwise specifically stated in the Act or rules or regulations framed thereunder, investment by a person resident outside India is prohibited in certain prescribed activities'.[10] There is also a prohibition on investments beyond investment limits, in violation of linked conditions and in excess of sectoral/statutory caps prescribed under the Regulations.[11]

Although there are many operative restrictions and prohibitions in the Regulations framed under FEMA, special powers have been vested with Reserve Bank of India in all restrictions on foreign investments prescribed therein.[12] There is also substantial discretion vested with other sector-specific regulators/ government departments and enforcement agencies.[13] It could be therefore be concluded that India's legal framework is based on comprehensive thought, deep deliberation, consensus on modalities and concentration of diversified set of laws to meet the pertinent objective.

2.] 'Restrictions' Explained:

Restrictions on receiving foreign investments as outlined in TISPROI Regulations, 2017 require further elaboration and understanding.[14] It has been stated that 'save as otherwise provided in the Act, rules or regulations made thereunder, an Indian entity or an investment vehicle, or a venture capital fund, or a firm or an association of persons or a proprietary concern shall not receive any investment in India from a person resident outside India or record such investment in its books' which has the composite effect of limiting entry of foreign funds in India without necessary process being followed and permissions executed.[15] Regulations make it aptly clear that unless allowed, there is a strict prohibition on receiving foreign investments by persons resident in India. However, RBI has exclusive power to permit such investments in India if an application is made to it and if the reasons are

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[9] Regulation 4 of TISPROI Regulations, 2017
[10] Regulation 15 of TISPROI Regulations, 2017
[11] Regulation 16 (B)(1) of TISPROI Regulations, 2017
[12] *Proviso* to Regulation 3, 4 of TISPROI Regulations, 2017
[13] See for example, Regulation 9 (2) of TISPROI Regulations, 2017
[14] Regulation 3 of TISPROI Regulations, 2017
[15] Regulation 4 of TISPROI Regulations, 2017

so satisfactory that investments could be allowed.[16] It should be noted here that there exists confusion in relation to interpretations to 'receiving' and 'conversion to use/ application' of the investments moved to an Indian entity. While restriction has been placed on receiving investments, there have been considerable debates on conversion to use in various case laws. In one case for example, it was noted by High Court of Madras that 'FDI Regulations permit FDI only by way of equity or compulsorily convertible instruments in Indian companies.[17]

It is not just that receiving foreign investments has been restricted in India by TISPRO Regulations, 2017 but other legislations also act in consonance with this.[18] Receiving foreign contributions by institutions, societies etc. for non-permitted purposes and without prior approval of the government have also been prohibited under Foreign Contribution (Regulation) Act, 2010.[19] It has also been stated that no persons shall receive otherwise through an authorized person, any payment by order or on behalf of any person resident outside India in any manner whatsoever without prior approval of Reserve Bank of India.[20] There is also power of central government to prohibit/ restrict foreign investments by making rules on a case to case basis.[21] It is however concluded that over a period of time, government has taken a relaxed view in relation to foreign investments in India and that restrictions have been duly addressed in view of emergent needs.

There has been a considerable focus of researchers and experts on the 'residuary power' vested with RBI in relation to receiving foreign investments whereby it is said that RBI on application being made to it, and for satisfactory reasons, allow FDI even though the same is not covered under the scheme laid down in Act, rules or regulations. This is incumbent due to the duty that RBI has to perform being the principal regulator of foreign exchange and transactions that occur between

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[16] Proviso to Regulation 4 of TISPROI Regulations, 2017
[17]Regulatory Insights from India Tax & Regulatory Services, PWC, https://www.pwc.in/assets/pdfs/news-alert tax/2016/pwc_news_alert_17_november_2016_supreme_court_sets_aside_bombay_high_court_judgement.pdf (19 FEB, 2019)
[18] See for example, Table Entry F.6, F.7, F.8, F.9 and F.10 of TISPROI Regulations, 2017
[19] Section 38 of Foreign Contribution (Regulation) Act, 2010
[20] Section 3(c) of FEMA, 1999
[21] Section 46 of FEMA, 1999

residents and non-residents.[22] There may be situations (both corrective as well as restorative) where there happens to be no choice for the regulators.

In the scheme of TISPROI Regulations, 2017, it has been provided that a person resident outside India can make investment to an entity resident in India by subscription, acquisition or transfer of securities or units thereof.[23] It has been made clear in the discussions above that subscription to securities is done at the time of incorporation of a company under the Companies Act, 2013[24]; acquisition is done when a company resident in India issues securities under the permitted schemes[25], and a person resident outside India is also eligible to make transfers when: **1.)** a person resident outside India transfers securities held by him to another person resident outside India (Overseas transfers), **2.)** a person resident in India transfers securities held by him to a person resident outside India (Outbound transfers) and **3.)** a person resident outside India transfers securities held by him to a person resident in India (Inbound transfers).[26] Here it should be reminded that although 'Act' for the purposes of TISPROI Regulations, 2017 means 'FEMA, 1999' but definition of 'transfer' under TISPROI Regulations, 2017 has been limited to transfer by sale or gift as compared to various other forms enlisted in FEMA, 1999.[27] Transfer of securities in all the above listed 3 patterns is subject to terms and conditions as indicated in the schedule Section 2 of FEMA, 1999 & Regulation 10 of TISPROI Regulations, 2017.[28]

4.] Restrictions on Overseas Transfers:

It has also been provided that a Non-Resident Indian (NRI) or Overseas Citizen of India (OCI)[29], holding capital instruments of an Indian company may transfer the same to a person resident outside India by way of sale or gift.[30] However, in case where a person resident in India acquires capital instruments in breach of aggregate sectoral limits as under the Schedule of TISPROI Regulations, 2017, the capital instruments must be mandatorily sold to a person resident in India within the

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[22] Preamble to Reserve Bank of India Act, 1934
[23] Regulation 2 (xvii) of TISPROI Regulations, 2017
[24] See Section 3 & Section 7 of Companies Act, 2013
[25] Section 23 of Companies Act, 2013 r/w Regulation 5(1) of TISPROI Regulations, 2017
[26] Regulation 10(1), 10(3) and 10(4) of TISPROI Regulations, 2017
[27] Section 2 of FEMA, 1999 & Regulation 10 of TISPROI Regulations, 2017
[28] Regulation 10 of TISPROI Regulations, 2017
[29] Registered as OCI under Indian Citizenship Act, 1955
[30] Regulation 10(2) of TISPROI Regulations, 2017

time allowed by RBI in consultation with the central government.[31] There is however a contrasting difference between who is a 'Non-Resident Indian' as two set of definitions of the term exist in Income Tax Act, 1961[32] and Foreign Exchange Management Act, 1999[33] respectively.

The issue of overseas transfers and indirect transfers has remained in considerable debate since a long period of time due to the CBDT's (Central Board of Direct Taxes) jurisdiction to tax income that has accrued or deemed to have been accrued out of operations in India.[34] India was criticized on this point for deteriorating the concept of 'preferred destination for investments' after government made amendment to the provisions of Income Tax Act, 1961 to bring all foreign transactions resulting in indirect transfer of assets located in India in retrospective scanner of CBDT by passing Finance Act, 2012.

5.] Strict Prohibitions:

There are certain sectors in which foreign investment & foreign technology collaborations are prohibited explicitly.[35] There were instances where representations against this prohibition were filed with the government to which government responded that foreign investment & foreign technology collaboration for such sectors in any form shall remain prohibited.[36] However, there always remain opportunities for foreign investors to exploit loopholes in FDI policy, most of which are brought to the concern of government by RBI periodically in order to avoid circumventing and misuse of omissions in policy statement.[37] Critical among the prohibitions is 'trading in transferable development rights (TDRs)' which is expressly prohibited for foreign investments.[38] First introduced in Mumbai in 1991, TDR is a framework where the government acquires land from the landowners for development rights that shall be

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[31] Proviso (ii) to Regulation 10 (2) of TISPROI Regulations, 2017
[32] Section 6 of Income Tax Act, 1961
[33] Section 2(w) of FEMA, 1999
[34] See *Vodafone Holdings BV* v. *Union of India*, where the Supreme Court has held that gains arising from the transfer of shares of a foreign company (resulting in indirect transfer of shares of Indian company) would not be subject to capital gains tax in India.
[35] Regulation 15 & 15 (9) of TISPROI Regulations, 2017
[36] DIPP (SIA) FC Division, Press Note No. 5 (2002 Series), F. No. 5(31)/2000-FC I dated 5th July 2002
[37] See e.g. SPS Pannu, *Loopholed FDI Policy allowing Foreign Funds flowing into Tobacco Sector- Says RBI*, India Today, 12 April, 2013 available at https://www.indiatoday.in/india/north/story/tobacco-companies-reserve-bank-of-india-rbi-foreign-direct-investment-fdi-policy-fdi-norms-p-chidambaram-finance-ministry-158523-2013-04-12
[38] Regulation 15 (5) of TISPROI Regulations, 2017

transferred to the landowner and places a winning situation to both developers as well as owners.[39] Although sincere efforts have been made to prevent any incidental flow of foreign investment in prohibited sectors, there is evidence of schemes adopted by foreign investors to gain indirect advantages by abusing the policy statements.[40]

There are two kinds of prohibition in the policy statement in TISPROI Regulations, 2017 that can be classified as express and implied prohibitions. Apart from express prohibitions under the regulations, there are implied prohibitions by using the terms 'subject to conditions & sector-specific requirements' in detailing the policy for permissible foreign investments.[41] There have been several debates on utility and objectives behind such implied prohibitions and demands for consistency and certainty in policy statement has always been the core idea. Imposition of implied conditions and successful compliance thereto reflects the intentions behind investment exercise by the 'Persons resident outside India' and government defies risks to domestic economy by allowing those to operate who invest for shared objectives.

Another important point for consideration here is about the government's calculation and assessment of en masse exit of foreign investors from Indian economy due to which various restrictions and prohibitions have been prescribed. In detailed analysis by experts, it has been revealed that excessive dependence or expectation from foreign investors would put the domestic economy at greater risk and government should always make informed decisions though segments of the society may oppose policy statements.[42] There are also other issues such as establishment of financial sector appellate tribunal, preventing indigenous contagion risks etc that have dominated the framework and public interactions regarding these have also been convened by the regulators.

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Restriction on amount of investment in Indian entities is controlled by prescribing sector-wise sectoral caps that is meant to operative limit for maximum investment including downstream investment as well.[43] It is also prescribed that it

[39] M. L. Mahesh, *TDRs- A Winning Formula for All*, The Hindu- 22 May, 2015 available at https://www.thehindu.com/features/homes-and-gardens/tdr-a-winning-formula-for-all/article7235427.ece

[40] Ramanuj, FDI in India in Legal Gambling- Is it Possible? Available at https://glaws.in/2011/07/15/foreign-direct-investment-in-india-in-legal-gambling-is-it-possible/

[41] See e.g. Table Entry at SL No 3.2, 3.3, 7 etc of Regulation 16 of TISPROI Regulations, 2017

[42] Report of the Working Group on Foreign Investment, Department of Economic Affairs, Ministry of Finance, 30 July- 2010, Government of India

[43] Regulation 2 (xxxix) of TISPROI Regulations, 2017

shall be the duty of Indian entity receiving foreign investment to ensure compliance with the sectoral/ statutory caps on such foreign investment and attendant conditions, if any.[44] The central idea behind prescription of such sectoral caps is to regulate the level and quantum of foreign ownership of Indian entities so that a situation of en masse exit does not disturb stability of Indian economy.[45] It is thoughtful however that up to what extent, Indian government has been able to achieve the objective really behind concept of sectoral caps? For instance, under Press Note 2 of 2009, if foreign investment in an Indian firm is less than 49%, then there is no bar on it to enter the sectors prohibited for overseas investments. This is because foreign investment below 50% of an Indian investing company shall not be considered for calculation of indirect overseas equity which led to great confusion amongst the members of industry as well RBI.[46] It is not that the problem was not responded, it is about the possibility of similar other issues and instances of misuse of FDI sectoral caps. It should also be convinced to thought and deliberation that higher sectoral caps or 100% permission is not the key to solve capital problems in India.[47] Rather, the government should always make policy statement that can attract long term investors to sectors in focus.[48]

6.] Concluding Remarks:

An interesting move in the scenario was made by the government when it allowed for merger/ demerger/ amalgamation of Indian companies with foreign companies[49] thereby permitting merger of Indian companies with foreign companies under a scheme backed with necessary approvals for the purpose.[50] It has also been indicated that in an event of merger of Indian company with a foreign company, if the sectoral caps or attendant conditionalities are incidentally breach, approvals for the scheme could be obtained from the central government.[51]

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[44] Regulation 16 (7) of TISPROI Regulations, 2017
[45] Report of the Working Group on Foreign Investment, Department of Economic Affairs, Ministry of Finance, 30 July- 2010, Government of India
[46] Livemint, *FEMA to check breach of FDI Sectoral Cap- says DIPP*, 21 June, 2009
[47] See e.g. Prasanta Sahu, *PFRDA seeks easing of FDI norms for pension funds, expects boost for fledgling segment*, Financial Express, 16 October 2018
[48] See e.g. https://www.bloombergquint.com/markets/what-would-an-fdi-limit-hike-mean-for-indian-banking-sector#gs.0xwBENGa
[49] Section 234 of Companies Act, 2013
[50] FEM (Cross Border Merger) Regulations, 2017; Notification no FEMA 389/ 2018-RB dated 20 March, 2018
[51] *Proviso* to Regulation 9 (1)(a) of TISPROI Regulations, 2017

It would not be appropriate to say that prescribing sectoral caps is a cumbersome task for the government due to the reasons and risks associated with it. It shall be proper if the same is left to the guidance of requirements, economic conditions and assessment of market risk by the government. Sectoral cap is not just a mere calculation of ownership of an Indian entity but is also an index that reflects dependence of entities on foreign investments and contagion of avoidance in domestic investors. Apart from permissible percentage which is prescribed through the policy statement, sectoral cap should also be considered as conditionalities and subjections to which the limit is annexed with. There have been instances of creative planning to circumvent the sectoral caps, layering of investments and non-disclosures which puts Indian entities to a great risk. Sincere efforts in monitoring investment limits, reporting and compliance also need to be undertaken so that instances of abuse and loss may be minimized.

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