

# FOREIGN EXCHANGE MANAGEMENT ACT, 1999



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## *Introduction*

Earlier, the limited supply of foreign exchange (forex) in India led to it being controlled to a great extent. Then the forex was regulated by the Foreign Exchange Regulation Act, 1947, which was later replaced by the Foreign Exchange Regulation Act (FERA), 1973. The FERA imposed strict regulations on certain kinds of payments, dealings in foreign exchange and securities, the transactions which had an indirect impact on the foreign exchange and the import and export of currency notes and bullion. As the Forex position of our country improved substantially due to improved foreign trade and commerce, the stringent provisions of the FERA became unrealistic and were not compatible with India's Liberalization Policy. It was to keep up with the changed scenario that the FERA was replaced by the Foreign Exchange Management Act, 1999.

The Foreign Exchange Management Act (FEMA) was enacted in 1999 and became effective on June 1, 2000. It extends to the whole of India. FEMA is a regulatory mechanism that enables the Reserve Bank of India and the Central Government to pass regulations and rules relating to foreign exchange in tune with the Foreign Trade policy of India.

## *Broad Provisions of the Act*

- Dealings in forex
- Current Account and Capital Account transactions- Current Account Transactions can be carried out without prior permission within a broad framework. The Central Government can impose reasonable restrictions by issuing rules. Capital account transactions are permitted to the extent specified by RBI
- Export of goods and services and the realization and repatriation of foreign exchange- Export proceeds are to be realized within 9 months from the date of export for all exporters
- Authorized persons (AP) - Since the RBI cannot directly deal with foreign exchange, the Central Bank has authorized persons to deal in the same. The RBI issues directions to AP through AP(DIR) circulars

- Contraventions and Penalties– The FEMA defines the consequences of contravening any provision of the Act
- Adjudications and appeals- The FEMA deals with appointment of adjudicating authorities, appeals against the decisions of the different levels of authorities, provisions regarding the composition, powers, etc of the Appellate Tribunal
- Directorate of Enforcement- Directorate of Enforcement consist of the Director and other officers of enforcement. The officers are empowered to conduct investigations into suspected contraventions of the Act, adjudicate, contraventions, and impose penalties on those adjudged to have contravened the law
- Other miscellaneous provisions such as the power of the Central government to suspend the operations and later relax the suspension if it considers necessary, to make rules to carry out provisions of the Act, to give directions to the RBI, etc

Besides the Act, there are rules and regulations that help implement the Act. Rules deal with Encashment of Draft, Cheque, Instrument and Payment of Interest; Authentications of Documents; Current Account Transactions; Adjudication Proceedings and Appeal; Compounding Proceedings; Recruitment, Salary and Allowance and Other Conditions of Service of Chairperson and Members.

Regulations deal with Permissible Capital Account Transactions; Borrowing or Lending in Foreign Exchange; Deposit; Acquisition and Transfer of Immovable Property Outside India; Guarantees; Realization, Repatriation and Surrender of Foreign Exchange; Foreign Currency Accounts of a person resident in India; Possession and Retention of foreign currency; Transfer or Issue of any Foreign Security; and much more

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## *Master Circulars & Master Directions by the RBI*

Every year on the 1<sup>st</sup> of July, the RBI issues Master Circulars on a particular subject. These Circulars expire on June 30<sup>th</sup> of the next year. From January 2016 the RBI has started issuing Master Directions on all regulatory matters. They consolidate the instructions and rules formulated by the RBI under various Acts including foreign exchange transactions. The existing master circular on various subjects will stand withdrawn on the issuance of the Master Direction of that subject. Over 360 Master Circulars have been reduced to 19 Master Directions on Foreign Exchange Management, of which 17 have already been issued and are available on the public domain. Here, we have discussed a few such regulatory matters that have been dealt with by the Master Directions and where not available, Master Circulars.

*Authorized Persons*- As mentioned before, Authorized Persons (AP) are those persons who have obtained approval from the RBI to deal in forex or in foreign securities as an Authorized dealer, money changer, off-shore banking unit or in any other manner it deems fit. Such an authorization can also be revoked. They are required to comply with the directions and orders issued by the RBI. The APs are required to take a declaration from the person for whom a forex transaction is being engaged in, that the transaction will not contravene any provision of the Act. There are 3 categories of authorized dealers- Category I, II and III. If the AP believes that the person shall engage in any such contravention, the AP is required to report the same to the RBI.

*Money Changing Activities* – The RBI authorizes certain persons to undertake money changing activities (Authorized Money Changers [AMCs]). AMCs can be Fully Fledged Money Changers (FFMCs), Authorized Dealer (AD) Category I Banks or AD Category II entities who are allowed to deal in foreign exchange for specified purposes. FFMCs are authorized to purchase forex from residents and non-residents visiting India and to sell forex for private (except for trip to Nepal or Bhutan) and business travel purposes only. FFMCs can be single or multiple branched based on their Net Owned Funds. The RBI also allows certain categories of AMCs carry on Restrictive money changing business through their agencies. Foreign exchange in any form can be brought into India freely without limit provided it is declared on the

Currency Declaration Form (CDF) (Declaration if it exceeds a specified limit). Forex obtained from AD or AMC can be taken out by residents. Non-residents can take out forex without restriction provided it does not exceed the amount brought in. AMCs and their franchisees can freely purchase forex from the public. They can issue encashment certificates, cash memos and purchase forex from other AMCs and ADs. They can also issue Forex pre-paid cards to Indian Residents. All AMCs have to submit their Annual audited Balance Sheet and Certificate of Net Owned Funds to the RBI.

*External Commercial Borrowings (ECB)*- ECBs are commercial loans raised by eligible resident entities from recognized non-resident entities and should conform to parameters in totality, such as minimum maturity, permitted and non-permitted end-uses, maximum all-in-cost ceiling, etc. ECBs can be-

- Track I- Foreign Currency ECB with a minimum average maturity of 3 years (for up to USD 50m or its equivalent) or 5 years (beyond USD 50m or its equivalent), both being medium term, OR
- Track II- Foreign Currency ECB with a minimum average maturity of 10 years (irrespective of amount) being long term; OR
- Track III- Indian Currency ECB of minimum average maturity of 3 years (for equivalent of up to USD 50m) or 5 years (beyond equivalent of USD 50m).

Entities eligible to raise ECB, their lenders, end-use prescriptions and the all-in-cost, all depend on the Track. ECBs can be in the form of loans, Securitized instruments, Buyers' or Suppliers' Credit, Foreign Currency Convertible Bonds (FCCBs), Foreign Currency Exchangeable Bonds and Financial Lease. ECBs can be raised through AD Category 1 banks (Automatic Route) or by approval from RBI (Approval Route). FCEBs can be issued only through the latter. Individual limits for ECBs that can be raised through automatic route are –

- Infrastructure and Manufacturing Companies – Up to USD 750m or its equivalent
- Software Development Companies - Up to USD 200m or its equivalent
- Entities engaged in micro finance activities - Up to USD 100m or its equivalent

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➤ Remaining Entities - Up to USD 500m or its equivalent

Approval route is required after exhaustion of the prescribed limits. Track I & II ECBs are required to follow hedging guidelines, if any, issued by the concerned sectoral or prudential regulator. ECB funds can be parked abroad as well as in India in the prescribed manner. ECB can also be converted into equity. Borrowers are required to obtain a Loan Registration Number (LRN) for any drawdown or payment of fees for raising ECB. Changes in the T&C in the ECB should be reported within 7 days of change. Borrowers have to submit a statement of ECB transactions in the ECB 2 Return, on a monthly basis, to the AD Category I bank in a way that it reaches the Department of Statistics and Information Management within 7 days of the close of the month.

*Liberalized Remittance Scheme (LRS)* - Under this scheme, Authorized Dealers freely allow remittances of up to USD 250,000 by resident *individuals* (including minors) per Financial Year for any permitted current or capital account transaction or a combination of both. The LRS permits the opening of a foreign currency account abroad with a bank, purchase of property abroad, making specified investment abroad, extending loans in INR to NRIs who are relatives under Companies Act, 1956 and setting up wholly Owned Subsidiaries and Joint Ventures (w.e.f. 05/08/2013) outside India for bonafide business. The limit of USD 250,000 includes transactions for private visits abroad (Except Nepal and Bhutan), gift, donations, employment abroad, business trips, etc. PAN is necessary for making remittances in excess of USD 25,000. Form A2 must be furnished for the purchase of forex under the LRS. An investor can retain and reinvest the income earned on investments made under the LRS.

## *Foreign Investments in India-*

### *Foreign Direct Investment (FDI)-*

- Under FDI, investments can be made by non residents in -
  - Equity Shares
  - Mandatorily and fully convertible debentures
  - Preference Share capital; all of Indian Companies
- Investment can be made through-
  - Automatic Route- Neither the investor nor the company require approval from the RBI or the Central Government.
  - Government Route- Either the investor or the company should obtain prior permission from-
    - Foreign Investment Promotion Board (FIPB);
    - Department of Economic Affairs(DEA);
    - Ministry of Finance or Department of Industrial Policy & Promotion (DIPP); as the case may be

- Investment can be made according to the FDI Policy of the Government and the FEMA regulations. An entity incorporated or a citizen of, Bangladesh/ Pakistan will require permission from the FIPB in addition to the above. NRIs resident in Nepal and Bhutan, as well of citizens of the said countries can invest in shares and convertible debentures of Indian Companies on repatriation basis, provided the investment is made through inward remittance of free forex, through normal banking channels. Overseas Corporate Bodies, not under the adverse notice of the RBI (certification required for the same) and which are incorporated in India, can make investment with prior approval of the Government if investment is through Government Route, or of the RBI if through automatic route.
- There is a minimum lock-in period of 1 year or as prescribed under FDI Regulations, whichever is higher, from the date of allotment. The investor will not be guaranteed any assured exit price at the time of making investment. After the lock in period, the investor is eligible to exit .
- In case of fresh issue of shares, 25% of the consideration amount should be received upfront in the case of partly paid equity shares and warrants. The balance consideration of fully paid equity shares should be received within 12 and 18 months respectively. The time period of 12 months is not insisted in cases where the issue size exceeds Rs. 500Cr and the issuer complies with the relevant SEBI regulations (for both unlisted and listed companies).
- Foreign investment in **any form** is prohibited in any entity engaged in business of chit fund (exception to NRIs subject to certain conditions), Nidhi Company, agriculture or plantation activities, real estate, construction of farm houses or Trading in Transferable development rights.
- FDI is specifically prohibited in Lottery Business, Manufacturing of Cigars, cheroots, cigarillos and cigarettes, of tobacco or of tobacco substitutes and Activities / sectors not open to private sector investment.
- LLPs are eligible for FDI under the Government Approval Route.

#### *Foreign Portfolio Investment-*

- Foreign Institutional Investors (FIIs) are institutions established outside India for making investment in securities in India. FIIs registered with SEBI are eligible to purchase shares, convertible debentures and warrants issued by Indian

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companies under the Portfolio Investment Scheme (PIS). NRIs are allowed to purchase the above mentioned securities in they have permission for the designated branch of any AD Category 1 bank.

- NRIs are allowed to invest in shares of listed Indian Companies under PIS. They can invest through designated ADs, on repatriation and non repatriation basis, up to 5% of the paid up capital/ paid up value of each series of debentures of listed companies. The aggregate paid up value of shares/ convertible debentures purchased by all NRIs should not exceed 10%. This limit of 10% can be raised to 24% by passing a Board Resolution and then a Special resolution , which should be intimated to the RBI along with a certificate from the Company Secretary stating that all provisions of the FEMA regulations and FDI policy have been complied with.
- FIIs are not permitted to invest in the Defense Industry subject to Industrial License. NRIs are allowed to subscribe in chit funds on non-repatriation basis.
- NRIs can open a single NRE/NRO account.
- SEBI registered FIIs can trade in all exchange traded derivative contracts approved by RBI/SEBI on recognized Stock Exchanges in India subject to the position limits, stipulations regarding collateral securities and margin requirements. NRIs can invest in Exchange Traded Derivative Contracts approved by SEBI from Rupee funds held in India on non-repatriation basis, subject to the limits prescribed by SEBI.
- FIIs registered with SEBI and SEBI approved sub-accounts of FIIs are permitted to short sell, lend and borrow equity shares of Indian companies. NRIs have to take delivery of the shares purchased and give delivery of shares sold. Short Selling is not permitted. (Short selling makes it possible to sell what one does not own, by borrowing the asset or instrument in question, selling it, and then buying it back to replace the borrowed asset).
- SEBI registered FIIs are permitted to invest in an Indian company through offer/private placement, subject to total and individual FII investment limits.
- An Indian company raising the aggregate FII and/or NRI investment limit should intimate the RBI.
- Qualified Foreign Investors(QFI) can make investments in all investments eligible to them. QFIs are persons resident in a country that is a member of Financial Action task Force (FATF) or a member of a group which is a member of

FATF, AND Resident in a country that is a signatory to IOSCO's MMoU or a signatory of a bilateral MoU with SEBI. Provided the person -

- Is not resident in India
  - Is not registered with SEBI as a FII or Sub-Account of an FII or Foreign Venture Capital Investor (FVCI)
  - Is not resident in a country listed in the public statements issued by FATF on specified jurisdictions.
- QFIs can open a dedicated Demat account with a Qualified Depository Participant in India for investment in equity shares under the scheme.
- The 'Foreign Portfolio Investment' scheme provides a framework for investments by FII and QFI. Under the scheme, the existing investor class, namely, FII and QFI are subsumed under portfolio investor registered under SEBI, called 'Registered Foreign Portfolio Investor (RFPI)'.
- The individual and aggregate investment limits for the RFPIs are below 10% or 24% respectively of the total paid-up equity capital or of the paid-up value of each series of convertible debentures. Where there is composite sectoral cap under FDI policy, these limits for RFPI investment shall also be within such overall FDI sectoral caps.
- RFPI are eligible to open a SNRR account and a foreign currency account with AD bank.
- They can invest in government securities and corporate debt subject to limits.
- RFPIs are to report the transaction to RBI in LEC Form

#### *Foreign Venture Capital Investor (FVCI)-*

- An FVCI can invest in Indian Venture Capital Undertaking (IVCU) or Venture Capital Fund (VCF) or in a scheme floated by such VCFs, provided the domestic VCF is registered with SEBI.
- An IVCU is a company incorporated in India whose shares are not listed in India and which is not engaged in an activity under the negative list specified by SEBI. A VCF is a fund established in the form of a trust, a company including a body corporate and registered under the SEBI (Venture Capital Fund) Regulations, 1996, which has a

dedicated pool of capital raised in a manner specified under the said Regulations and which invests in Venture Capital Undertakings according to the said Regulations.

- FVCIs can purchase equity/ equity linked instruments/ debt/ debt instruments, debentures of an IVCU or of a VCF or in units of schemes/ funds set up by a VCF through IPO/ private placement/ private arrangement/ purchase from third party. Further, FVCIs are allowed to invest in listed securities
- FVCI can open a non-interest bearing Foreign Currency Account and/or a non-interest bearing Special Non-Resident Rupee Account with a designated branch of an AD Category – I bank
- AD Category – I banks can offer forward cover to FVCIs to the extent of total inward remittance

#### *Other Foreign Investments*

- NRIs can purchase shares, convertible debentures and warrants issued by an Indian company and Government securities, treasury bills, units of domestic mutual funds, units of Money Market Mutual Funds on non-repatriation basis without any limit.
- NRIs are not permitted to make Investments in Small Savings Schemes including PPF
- NRIs can invest in non-convertible debentures issued by an Indian Company and in non-convertible/redeemable preference shares or debentures, both on repatriation basis and on non-repatriation basis, subject to certain terms and conditions
- NRIs can purchase on repatriation basis, without limit, Government dated securities (other than bearer securities)/ treasury bills/ units of domestic mutual funds; bonds issued by a public sector undertaking (PSU) in India and shares in Public Sector Enterprises being disinvested by the Government.
- NRIs can subscribe to National Pension System, provided the person is eligible to invest as per the PFRDA Act. The annuity/ accumulated saving will be repatriable

- RFPs, FIIs including SEBI approved sub-accounts of the FIIs, registered with SEBI and NRIs may invest, purchase, hold and transfer Indian Depository Receipts of eligible companies resident outside India and issued in the Indian capital market
- A Multilateral Development Bank (MDB) specifically permitted by the Government to float rupee bonds in India can purchase Government dated securities
- Eligible non-resident investors are allowed to invest on repatriation basis in (i) Rupee and Foreign currency denominated bonds issued by the Infrastructure Debt Funds (IDF) set up as an Indian company and registered as NBFCs and in (ii) Rupee denominated units issued by IDFs set up as SEBI registered domestic Mutual Funds (MFs)
- RFPs, FIIs, QFIs and Long Term Investors can purchase other specified securities and units of Domestic Mutual funds in accordance with stipulated conditions.

*Liaison Office/ Branch Office/ Project Office –*

Foreign companies engaged in manufacturing and trading may establish a *branch office* (BO) with specific approval of the RBI to transact specified activities as follows:

- Export/import of goods;
- Provision of professional or consultancy services;
- Conducting research in areas where the head office carries out activities;
- Promoting technical or financial collaboration between Indian companies and their head office or overseas group company;
- Representing the head office in India and acting as a buying/selling agent in India;
- Providing information technology (IT) services and developing software in India;
- Providing technical support for products supplied by the head office and/or group companies; and

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- Engaging in a foreign airline/shipping business.

Branch offices are not allowed to carry out retail trading, manufacturing or processing activities in India, directly or indirectly. Profits earned from the BO are freely remittable from India, after payment of applicable taxes. BOs can also be established in SEZs. Foreign banks do not require special permission under the FEMA to open BO.

*Liaison offices* (also known as representative offices) are prohibited from undertaking any business activity or generating income in India; expenses of a liaison office must be met through currency remittances from the head office. Liaison offices can collect information about possible market opportunities and provide information about the company and its products to prospective Indian customers. Liaison offices may promote exports from and imports to India. They can also promote technical or financial collaborations between parent/ group companies and Companies in India. They can represent their parent office in India and act as a channel of communication between the parent company and Indian companies. The validity period of an LO can be extended by application, by a period of three years, on the fulfillment of certain conditions.

For opening an LO/ BO approval can be acquired by –

- RBI Route- Where principal business of the foreign entity falls under sectors where 100% Foreign Direct Investment (FDI) is permissible under the automatic route.
- Government Route- In cases other than the above. These applications and those from NGOs/Non Profit Organizations/Governments Bodies/ Departments are considered with consultation with the Ministry of Finance

For opening a BO/LO, the foreign entity-

- Should have a made profits in the preceding-

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- 5 financial years in the home country in the case of BO
- 3 financial years in the home country in the case of LO
- AND the Net worth of the latest Certified Balance Sheet or Account Statement should be at least-
  - USD 100,000 or its equivalent in the case of BO
  - USD 50,000 or its equivalent in the case of LO

LO/BOs approved by the RBI are allotted a UIN (Unique Identification Number) and they are also required to obtain a PAN.

*Project Offices (POs)* are offices established by foreign companies in India for the execution of project secured from an Indian Company. POs have been granted general permission for their establishment by the RBI if the project–

- Is funded directly by remittance from abroad, OR
- Is funded by bi/multilateral International Financing Agency, OR
- Has been cleared by the appropriate authority, OR
- The contractee has been granted a Term Loan by a Public Financial Institution or a bank in India.

In any other case RBI approval is a must. Government Route is required for POs by foreign NGOs/ Non-Profit Organizations/Foreign Government Bodies/Departments. They can open foreign currency accounts in India and do intermittent remittances subject to certain conditions.

No LO/ BO/ PO can be established by a person who is a citizen or registered in Pakistan, Bangladesh, Sri Lanka, Afghanistan, Iran, China, Hong Kong or Macau. BO/POs are allowed to purchase immovable property for official use in India. BO/PO/ LOs are allowed to lease property provided the lease period does not exceed 5 years and open non-interest bearing INR bank accounts. Authorized Dealers are allowed to keep term deposits in favor of BOs, from

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temporary surpluses for a period of not more than 6 months provided the proceeds are utilized within 3 months for business in India.

LO/BO/POs are required to submit a report containing information, within 5 working days of their becoming functional to the Director General of Police (DGP) of the respective state.

A BO, representative office or LO must be registered with the ROC and must file Annual Activity Certificates, annual financial statements (covering worldwide and Indian operations) and other documents (for example, relating to changes in the registered/principal office of the foreign company, changes in directors/secretary of the foreign company, changes in the charter or statute or memorandum and articles of association of the foreign company).

A PO is to furnish a report through the concerned AD branch, to the concerned Regional Office of RBI under whose jurisdiction the PO is set up, within 2 months of its establishment. Annual Certificate from a Chartered Accountant showing the Project Status and certifying that the accounts of the PO have been audited and the activities undertaken are in conformity with the permission given by the RBI.

*Immovable property outside India*- A person is resident in India can acquire property outside India if permitted by the FEMA or with permission from the RBI. These restrictions do not apply to the property held by an Indian resident who is a foreign national or if the property was acquired by an Indian resident on or before 08/07/1947 and continued to be held by him with the permission of the RBI or if acquisition of property outside India by an Indian resident is on a lease not exceeding 5 years. An Indian resident can own, transfer or invest in any immovable property outside India if such property was acquired when he/she was resident outside India or as inheritance or gift from specific persons resident outside India. A resident can purchase immovable property outside India out of foreign exchange held in their Resident Foreign Currency (RFC) A/c. He can also acquire such property jointly with a relative who is resident outside India, provided there is no outflow of funds from India. A company incorporated in India having overseas offices, may acquire

immovable property outside India for its business and for residential purposes of its staff, provided total remittances do not exceed the limits prescribed for initial and recurring expenses.

*Direct Investment by Residents in Joint Venture (JV) / Wholly Owned Subsidiary (WOS) Abroad-* Such investments have been recognized as important avenues for promoting global business. Overseas investment can be made through the Automatic Route (upto prescribed limits of net worth) as well as the Approval Route by way of contribution to the capital or subscription to the Memorandum of a JV/WOS or by way of purchase of existing shares either by market purchase or private placement or through stock exchange. An Indian party, i.e. a company incorporated in India, a body created under an Act of Parliament, a registered partnership firm, a registered LLP or any other entity in India notified by the RBI, is allowed to make investment under automatic route. They are not allowed to make investment or financial commitments in foreign entities engaged in certain real estate activities or banking business without approval from the RBI.

Under the automatic route the procedure can be carried out through AD Cat. I banks. For net worth of an Indian party, the net worth of its holding company or subsidiary company may be taken into account to the extent not availed of by the holding company or the subsidiary independently and has furnished a letter of disclaimer in favor of the Indian Party. The limit of net worth is not applicable where investment is made out of EEFC account of the Indian Party.

The Indian Party should not be on any caution list/ list of defaulters or be under any investigation, and all the transactions relation to the investment in a JV/WOS should be made through a single AD Cat. 1 bank. Prior permission of the RBI is required to create a pledge/mortgage/hypothecation/charge on immovable/moveable property or other financial assets of Indian party/group companies in favor of a non- resident. Investment in Pakistan is allowed under the approval route, investments in Nepal can only be in INR and investments in Bhutan are allowed in INR and in freely convertible currencies.

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Proposals that are not covered by the automatic route, require permission from the RBI under Approval Route. Overseas Investments by proprietorship concerns, unregistered partnership firms and Registered Trusts / Societies, all satisfying certain eligibility criteria, need to proceed under the Approval Route. Also, individual partners can hold shares on behalf of the firm in an overseas JV/WOS, where the entire funding for the investments has been done by the firm and the host country regulations allow such holding.

One of the obligations of an Indian Party making overseas investment is to submit to the RBI through the AD Cat. 1 bank on or before June 30 of every year, an Annual Performance Report (APR) in Part III of Form ODI in respect of each JV or WOS outside India. The APR has to be based on the audited annual accounts of the JV/WOS for the preceding year, unless specifically exempted by the Reserve Bank.

Other than by way of direct investment, listed Indian companies can invest up to 50 % of their net worth as on the date of the last audited Balance Sheet in listed overseas companies, or in the rated debt securities issued by such companies. Resident individuals can acquire shares of a foreign entity in part / full consideration of professional services rendered to the foreign entity or in lieu of Director's remuneration within limits prescribed in the Liberalized Remittance Scheme. Domestic Venture Capital Funds registered with SEBI may invest in equity and equity linked instruments of off-shore VCFs subject to an overall limit of USD 500 million.

General permission is available to a resident for the purchase and sale of securities out of funds held in RFC account, bonus shares on existent holdings and when a when the person is not permanently resident in India, out of the foreign currency resources abroad. An Indian party is allowed to open, hold and maintain Foreign Currency Account (FCA) abroad for the purpose of overseas direct investments wherever allowed by the host country, subject to certain terms and conditions.

*For Information on Penalties and Compounding under FEMA, refer the publication on Penalties under Various Laws*

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