

Regulatory Hotline

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NAVIGATING THE REGULATORY LANDSCAPE: RECONCILING FCRA AND FEMA

Foreign investment and its regulation in India have undergone substantial scrutiny and evolution, leading to a complex interplay between various regulatory frameworks. This complexity is particularly evident in the interaction between the Foreign Contribution Regulation Act, 2010 ("FCRA") and Foreign Exchange Management Act, 1999 ("FEMA"). This paper explores the anomalies and inconsistencies that arise from the intersection of these two laws, highlighting the challenges faced by foreign investors and Indian entities in navigating the regulatory landscape.

1. UNDERSTANDING FOREIGN CONTRIBUTIONS: FCRA AND FEMA PERSPECTIVES

FCRA is a critical piece of legislation in India that serves to oversee and manage the acceptance and utilization of foreign contributions by specific entities, individuals, associations or companies within the country. Its primary objective is to prevent foreign funds from being used in activities that could undermine national interest or influence social, political, economic or religious discussions. S.2 (h) of the FCRA¹ defines 'foreign contribution' as any donation, transfer or income received from foreign sources, excluding payments for costs incurred in lieu of goods or services to Indian businesses. The Act mandates strict regulations for non-profits, requiring registration, annual reporting and compliance with eligibility criteria such as a minimum three-year existence and active engagement in societal beneficial activities.

Contrastingly, FEMA has evolved to accommodate the changing economic landscape, emphasizing a more liberalized approach towards foreign investments in India. FEMA primarily focuses on managing foreign exchange and facilitating external trade and payments.²

FEMA's scope extends to 'foreign securities,' encompassing various financial instruments denominated in foreign currency such as shares, stocks, bonds, and debentures. These instruments are characterized by an expectation of returns in Indian currency, including redemption, interest, or dividends.³ Unlike the definition of "foreign contribution" mentioned under FCRA, which refers specifically to donations, gifts or aid received from foreign sources to NGOs or other entities in India without any expectation of receiving any interest in return. While both the definitions involve foreign elements, foreign security deals with financial instruments and their returns in Indian currency, whereas foreign contribution pertains to contributions received from foreign sources for specific purposes within India with no expectation of any returns.

2. SECTION 8 COMPANIES AND FDI INFUSION

Under the Companies Act, 2013 ("Companies Act"), a Section 8 Company is defined as an organisation established to promote non-profit activities such as education, social welfare, environment preservation, sports, art etc. These entities operate as limited companies with restrictions on distributing dividends to members. However, in case of Section 8 Companies receiving foreign investment, the treatment of such investment from FCRA standpoint have raised certain questions.

The ambiguity arises from conflicting interpretations of the term 'contribution' under the FCRA and whether the infusion of foreign share capital should fall under this classification. Initial guidance from the Ministry of Home Affairs ("MHA") clarified that the infusion of share capital in Section 8 Companies constituted foreign contributions under FCRA.⁴ However, recent FAQs released by the MHA omitted this clarification⁵, intensifying uncertainties about the validity of share capital infusion and the necessity of prior approval from the central government under FCRA.

The crux of the matter lies in discerning whether the infusion of foreign share capital aligns with the definition of 'foreign contribution' under FCRA. As per the definition of 'foreign contribution' under FCRA, the primary purpose of 'donation' is a transaction where the element of quid pro quo is missing. However, the debate arises in cases of infusion of share capital in Section 8 company, when a particular investor invests in a Section 8 company. In a standard investment scenario, an investor investing in Section 8 company invest in the share capital of a company with the intent of receiving securities of the investee entity. Furthermore, the investor also has the option of transferring share in a Section 8 Company to recover the capital invested in the company on a future date. However, the given scenarios are not applicable to Section 8 companies under the FCRA route.

FEMA, in conjunction with the Foreign Exchange Management (Non-debt Instruments) Rules, 2019 ("NDI Rules"), delineates conditions for foreign residents investing in non-debt securities of Indian companies. Notably, FEMA's expansive definition of 'person' encompasses Section 8 Companies, implying no explicit prohibitions for investors leveraging the automatic route prescribed by FEMA to invest in these entities, subject to specified conditions and procedures.

The legal landscape governing foreign contributions within India was further elucidated in the case of *Noel Harper v.*

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Union of India.⁶ The case clarified the stringent regulatory environment overseeing foreign contributions within India, accentuating the interconnectedness of FEMA and the FCRA. This ruling elucidates the necessity for strict adherence to prescribed guidelines for permitting and utilizing foreign contributions, emphasizing that any inflow of foreign exchange, including share capital infusion for Section 8 companies, falls within the ambit of FEMA. It mandates compliance with FCRA and FEMA regulations, necessitating proper approvals and adherence to authorized utilization purposes for foreign contributions in line with the stipulations set by competent authorities.

Thereby, clearly indicating the fact that FCRA registration still remains a prerequisite for receiving foreign share capital in India, emphasizing compliance with both FCRA and FEMA provisions⁷.

Another key aspect being, as per Companies Act, a company can either be incorporated as limited by shares or by guarantee with or without share capital. In practice, Section 8 Companies are generally incorporated as company limited by guarantee without share capital as it seems a legally feasible structure wherein the founders are not under obligation to infuse share capital amount but to only remain as guarantor and necessary funds for carrying the operations would be brought by way of donations, subscriptions, grants, endowments, fees, etc. However, since FEMA (read with NDI Rules) on the other hand do not contemplate a situation of Indian company limited by guarantee without share capital and it allows an Indian entity (which includes Section 8 Companies) to raise FDI only by way of issuance of equity instruments to non-resident persons, it becomes clear that a Section 8 Company receiving foreign investment should necessarily be formed as a company limited by shares.

3. INCONSISTENCY IN FCRA AND FDI NORMS IN SECTORS LIKE MEDIA

The regulatory landscape again takes a complex turn when examining the treatment of media entities under FDI policy and FCRA. While FDI policy allows foreign investment in for-profit media houses,⁸ FCRA prohibits foreign contributions to non-profit electronic and print media. This inconsistency raises questions about the rationale behind the differential treatment.

Historical developments reveal the genesis of FCRA's restrictions on media entities. Initially enacted in 1976, FCRA barred foreign contributions solely in print media. Subsequently, in 2010, FCRA extended this prohibition to include electronic media. The rationale behind this prohibition, as articulated in a Parliamentary Standing Committee on Home Affairs report from October 21, 2008.⁹ The committee highlighting the influential role of electronic media in shaping public opinion and aimed to safeguard national interests by pre-empting potentially adverse foreign influences on non-profit media houses.

Contrarily, FDI policies underwent a transformation post-liberalization in 1991, permitting foreign investment in select sectors. Notably, the allowance of 26% FDI in print media in 2002 was intended to infuse capital and technology without altering ownership structures significantly.¹⁰ The legal principle of treating unequal entities differently is justifiable only when rooted in distinct circumstances and clear objectives. Notably, if the intent is to curb foreign influence due to media's opinion-shaping power, equality in treatment between for-profit and non-profit entities within the media sector is warranted.

Given the evolving landscape of India's FDI policies in contrast to the static nature of FCRA provisions, the need for alignment between the two regulatory frameworks becomes evident. A proposed solution involves amending FCRA by eliminating sections 3(1)(b), 3(1)(g), and 3(1)(h) to lift the ban on foreign contributions, subjecting media entities to FCRA registration requirements. Furthermore, the government could utilize its authority under section 9(d) of FCRA, mandating prior permissions for foreign contributions by not-for-profit media houses, bolstering an additional layer of scrutiny.

This proposed amendment aims to rectify the existing inconsistency between FDI policies and FCRA provisions within the media sector, fostering a conducive environment for the growth and development of non-profit media establishments in India while preserving national interests through regulated foreign contributions.

4. FOCC IN THE CONTEXT OF FEMA AND FCRA

The regulatory framework under FEMA significantly governs downstream investments and sets guidelines under NDI Rules. It mandates Indian entities receiving indirect foreign investments to adhere to specific entry routes, sectoral limits, pricing regulations and other conditions as applicable to foreign investments. Contrastingly, since inception, Foreign Owned and Controlled Companies ("FOCCs") fell under the FCRA's definition of "foreign source," necessitating compliance when contributing to CSR (corporate social responsibility) activities via registered NGOs or trusts. This led to challenges in FCRA registration, contribution monitoring and adherence to receipt norms, inviting legal repercussions for non-compliance. This anomaly continued until Finance Bill of 2016 which eventually provided a relief to FOCCs. The insertion of a proviso in FCRA (via the Finance Bill, 2018) deems FOCCs exempt from being labelled as the foreign source, if their nominal share capital aligns with the foreign investment limits outlined in FEMA. Consequently, contributions from such entities towards CSR cease to qualify as foreign contributions, alleviating the FCRA compliance burden. This exemption retroactively applies from the FCRA's enforcement date in 2010, absolving FOCCs from non-compliance under Section 135 of Companies Act, fostering a more streamlined corporate contribution landscape.¹¹

5. RECENT DEVELOPMENTS

Recently, the regulatory landscape governing international non-governmental organizations and donor agencies establishing offices in India underwent a significant transformation. Initially regulated by FEMA, the Reserve Bank of India introduced an amendment to its notification, mandating entities engaged in activities covered by FCRA to register under FCRA.¹² This pivotal shift was instigated by the MHA, driven by the objective of instituting a centralized oversight mechanism. The ministry had raised concerns about certain international NGOs exploiting a loophole by registering as liaison offices under FEMA, thereby evading obligations under FCRA. However, despite this notable shift, international NGOs and donor agencies are still afforded the option to register under FEMA, provided they comply with specific declarations prescribed by the authorities. This nuanced approach appears to indicate an effort to streamline regulatory oversight within a unified framework established by FCRA.¹³

Also, important to note that the liaison or branch offices as may be set up by international NGOs (subject to

compliance of FEMA) for undertaking not for profit activities in India may not qualify as a foreign company under Companies Act. This is since a foreign company has been defined under Companies Act to mean a foreign body corporate having a place of business in India and which conducts any business activity in India. By conducting not for profit activity, the 'business activity' test would not be fulfilled and hence, they are not to be treated as a foreign company.

CONCLUSION

The complex interrelation of FCRA, FEMA, and FDI policies in India highlights the pressing need for streamlined alignment and clarity within regulatory frameworks. Specifically, the disparities between treatment of media entities under FCRA and FDI policies call for strategic amendments aimed at harmonization, transparency and balanced regulation of foreign contributions. Implementing proactive legislative measures swiftly is crucial to reconcile these frameworks, fostering responsible foreign investments within specified boundaries while fortifying India's global competitiveness and safeguarding national interests with stringent compliance measures. This approach will not only encourage socio-economic growth but also uphold integrity, ensuring a robust position for India on the global stage.

– Sehar Sharma, Chandrashekar K and Rahul Rishi

You can direct your queries or comments to the authors.

¹<https://www.sconline.com/ Members/ BrowseResult.aspx#FN0001>

²<https://www.sconline.com/ blog/post/ 2020/12/14/ metamorphosis-of-fdi- regime-in-india-fera-to-fema/>

³<https://www.sconline.com/ blog/post/2020/12/14/ metamorphosis-of-fdi- regime-in-india-fera-to-fema/>

⁴https://www.mha.gov.in/sites/ default/files/2022-07/ Foreign-Foreign-FCRA_FAQs_1.pdf

⁵https://www.mha.gov.in/ sites/default/files/ 2022-07/Foreign-Foreign-FCRA_FAQs_1.pdf

⁶(2023) 3 SCC 544.

⁷For more details refer to: https://www.meity.gov.in/ writereaddata/files/ FDI-PolicyCircular-2020 -29October2020_0.pdf

⁸<https://thewire.in/ media/modi-governments- decision-to-place-26-cap- on-fdi-in-digital-media- raises-questions#:~:text=%E2%80%9CThe%20extant% 20FDI%20policy%20provid es,the%20lines%20of%20p rint%20media.%E2%80%9D>

⁹<https://fcra2010.in/ wp-content/uploads/ 2021/08/ Parliamentary-Report-2008.pdf>

¹⁰https://www.business-standard.com/ article/economy-policy/ journalists-politicians -judges-can-t-accept- foreign-money-under- fcra-117042100475_1.html

¹¹<https://pib.gov.in/ PressReleaseIframePage.aspx? PRID=1522983>

¹²RBI Notification No. FEMA 22(R) /RB-2016 of March 31, 2016

¹³<https://www.sdgphilanthropy.org/ system/files/2020-10/ India%20Philanthropy%20Law%20Report.pdf>

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