Regulatory Digest

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FOREIGN INVESTMENTS - RECONCILING FEMA AND COMPANY LAW

Foreign investments and its regulations in India have undergone substantial scrutiny and evolution, leading to a complex interplay between various regulatory frameworks. In this paper, we have discussed some noteworthy anomalies that arise from the intersection of the Companies Act, 2013 (the "**Act**") including the rules thereunder (together, "**Company law**") and Foreign Exchange Management Act, 1999 ("**FEMA**"), highlighting the practical challenges faced by the foreign investors and Indian entities in navigating the regulatory landscape.

A) INITIAL MOA SUBSCRIPTION – 'DATE OF ISSUE':

Company law: When non-resident persons incorporate a company in India and subscribe to its memorandum of association (MoA), such persons, being the MoA subscribers, are required to infuse initial capital amount into the company within 180 days from date of incorporation else, such company will not be eligible to commence business operations (Section 10A of the Act)[1]. Further, Section 56[2] of the Act states that MoA subscribers should be issued share certificates within 2 months from the date of incorporation. Notably, the timeline for allotment of securities is prescribed as 60 days from date of receipt of subscription amount only for 'subsequent share subscriptions' (such as, rights issue, preferential offer etc.) and not for initial MoA subscription. This is since in case of initial MoA subscription, shares are deemed to have been allotted to MoA subscribers from date of incorporation ('**deemed allotment**') and share capital comes into existence from date of incorporation itself. Even the High Court of Bombay has taken similar view in the case of *Sant chemicals private limited Vs. Sant chemicals private limited with Aviat chemicals private limited and Jagmohan Singh Arora and others*[3]. This is the reason that the monies payable by MoA subscribers become a debt due from them to the company and it falls due from date of incorporation itself (Section 10(2) of the Act)[4]. Also, the deadline of 180 days has been set under law to ensure its recovery. The register of members maintained under the Act should also record the 'date of company's incorporation' as the 'date of becoming member' in case of initial MoA subscription. This suggests that initial MoA share subscription enjoys special status.

FEMA: On the other hand, FEMA requires to issue equity instruments to non-resident investors only after receipt of share subscription amount, within 60 days from the date of such receipt. Post issuance of equity instruments, details of such investment should be reported through Form FC-GPR wherein the 'date of issue' should mandatorily be disclosed. FEMA uses the word 'issue' and not 'allotment' however, looking closely at the regulatory framework makes it clear that the word 'issue' under FEMA should be construed as 'allotment' of shares.

Area of Anomaly: Unlike Company law, the concept of deemed allotment is not envisaged under FEMA and hence, the rule of receiving share subscription amount prior to issuance of equity instruments is applied to all the scenarios and the concept of deemed allotment, as available under Company law, is not available in case of initial MoA subscription. Owing to this disconnect in two laws, what should be the 'date of issue' for Form FC-GPR reporting in case of initial MoA share subscription merits careful consideration. Here, an immediate thought that may emerge is - *can the 'date of incorporation' be provided as 'date of issue' by applying deemed allotment concept of Company law?* To answer this, which amongst these two is the governing and applicable law needs to be analysed first. Basis careful study of key purpose and framework of two laws, it can be inferred that Company law is the primary law to deal with procedures applicable for issue/allotment of securities. Though FEMA intends to regulate foreign investment into Indian entities by imposing FDI conditions, in substance, it is not supposed to determine the procedures involved in issuance of securities *per se*. Hence, to answer the aforesaid question, one should strictly go by Company law principles and the mentioning of 'date of company's incorporation' as the 'date of issue' in such Form FC-GPR seems the appropriate approach and the same should not, in any case, be viewed as an incorrect filing or contravention under FEMA. However, practically, owing to this anomaly, FC-GPR forms which were filed for initial MoA subscription by applying Company law provisions, got rejected on the ground that shares cannot be issued prior to receipt of inward remittance. Unfortunately, neither Authorised Dealer (AD) banks nor the regulators have appreciated the special treatment given to initial MoA subscription under Company law. Consequentially, in such cases, either the companies are made subject to compounding and other legal consequences under FEMA or are compelled to provide different date of issuance subsequent to the inward remittance date to satisfy mere reporting norms thus, breaching the core principles laid down under Company law. As such, the date of issue of shares cannot be different under both the laws for initial MoA subscription case so this anomaly needs an immediate reconciliation.

B) CROSS-BORDER SHARE TRANSFERS – 'DATE OF TRANSFER':

Company law: From Company law standpoint, the shares held by a member is movable property transferable in a manner prescribed in the articles of association of the company ("**AoA**"), particularly for private companies where

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shares are not freely transferable. In addition to AoA restrictions, for physical share transfers, execution of securities transfer form in form SH-4 is a must which mandates to disclose the 'consideration received' from the transferee. This needs to be disclosed even in case of electronic/demat share transfers. So, it is clear that payment of consideration, as mutually agreed between the parties and subject to applicable pricing norms, should always occur prior to actual transfer of shares.

FEMA: On the other hand, FEMA comes into play only in case of cross-border (i.e., between resident and non-residents) share transfers amounting to FDI investment (or divestment). Rule 4 of the Foreign Exchange Management (Non-Debt Instruments) Rules, 2019 ("**NDI Rules**")[5] clarifies that as long as a particular cross-border share transfer is FEMA compliant, they should be taken on record under automatic route. It also requires the transferee to make payment of consideration prior to the transfer of shares however, Regulation 4(3) of the Foreign Exchange Management (Mode of Payment and Reporting of Non-Debt Instruments) Regulations, 2019 ("**NDI Reporting Regs**")[6] which requires filing of particulars of share transfer in Form FC-TRS stipulates to file it *within 60 days of transfer of equity instruments or receipt/remittance of funds, whichever is earlier.* Further, Para 6.2 of FDI Policy[7] (including the previous FDI policies) states that - *only upon receipt of the certificate from AD bank, the investee company may record the transfer (along with certificate in Form FC-TRS issued from AD bank) in its books*. Here the term 'books' under FDI Policy may be construed to be the register of members and share transfers maintained by Indian investee company under Company law.

***Areas of Anomaly*:**

- Under FEMA, in case of secondary share purchases, the transferee must remit purchase consideration in full (or at least 75% in case of deferred payment structure) to the transferor prior to transfer of shares. While this being the thumb rule, the expression '*transfer of equity instruments or receipt/remittance of funds, whichever is earlier'* used under Regulation 4(3) of NDI Reporting Regs creates unnecessary confusion.
- *Date of Transfer*: Combined reading of FEMA and Company law requirements suggest that, sequentially, the receipt/remittance of funds needs to take place first, followed by which, Form FC-TRS to be filed within 60 days with AD bank. Only upon receiving an approval copy for such reporting and that the parties execute form SH-4 (or delivery instruction slip in case of demat shares) as well as comply with the applicable AoA restrictions, the investee company has to take on record/approve the same. This clarifies that at the time of filing Form FC-TRS, the reporting party would not know the actual date of transfer of shares in the company's books. Legally, even after Form FC-TRS is approved by AD bank for proposed cross-border share transfer, it is possible that such transfer may be rejected by the company on the grounds of breach of any AoA covenant (particularly in case of private companies). Similar view was taken by the RBI offices in the past few cases wherein Indian investee companies were directed to take cross-border share transfers on record only after obtaining approval for Form FC-TRS reporting, and any deviation here was held in contravention of Rule 4 of NDI Rules [or corresponding provision under erstwhile FEMA(20)[8] and FEMA(20R)[9]]

  However, contrastingly, existing Form FC-TRS[10] mandates to disclose 'date of transfer', which seems to clearly contradict with FDI Policy, and the sequence of events discussed above. On this point, the RBI's FDI reporting manual clarifies to select the date of application itself as date of transfer (where the date of transfer is future date) or to provide the date of transfer as per share transfer agreement. This clarification is vague and allows to select any practically convenient date without appreciating the legalities around determining the date of transfer. In practice, the AD banks are relying on this and are approving Form FC-TRS filings basis such different date being provided. Consequentially, such transactions may end up having two different 'dates of transfer' under these two statutes (i.e., one which is provided purely for FEMA reporting purposes and the other being the actual date of transfer determined as per Company law after considering other legalities like AoA restrictions, procedures etc.), leading to absurdity. Besides, if one tries to fix this issue by recoding the share transfer as per Company law first and then file Form FC-TRS with that actual transfer date, this may still be viewed as contravention of Para 6.2 of FDI Policy at a later date.

C) RIGHTS ISSUE OF SHARES:

Both Company law and FEMA explicitly recognize the rights issuance including renouncement of right issue entitlement by the existing shareholders. However, under FEMA, the FDI reporting mandatorily requires furnishing a copy of acknowledgment of original investment. Given this, where such right has been renounced in favour of a non-resident who is not an existing shareholder (as Company law permits), then the acknowledgment of original investment becomes irrelevant. In this scenario, whether the investment by that renouncee would still be treated as an FDI under rights issue route itself remains a question from FEMA standpoint. Another key anomaly being the Company law empowers the board of directors to allot any rights issue unsubscribed shares to any person (including non-resident) however, this is not envisaged under FEMA. If the company's board allots such unsubscribed shares to any non-resident person who may or may not be an existing shareholder, in such cases, how to categorise that investment and applicability of pricing norms under FEMA remains unclear.

Also, in case of Compulsorily Convertible Debentures (CCDs), though they are treated as equity instruments at par with equity shares under FEMA and therefore, investment in CCDs under rights / bonus issue seems a possible option under Rule 7 of NDI Rules, such offer should comply with Company law also and contrastingly, Company law does not recognise CCDs as shares but as a debt instrument, and allows rights / bonus issuance of only shares. Resultantly, such investments are deprived of certain benefits available under these routes.

D) OTHER ANOMALIES

Company law allows preferential issuance of shares and convertible securities for non-cash consideration subject to pricing norms stated thereunder. FEMA also allows this in a few scenarios (including swap of shares) involving issuance of shares to non-resident persons. However, in case of Foreign Owned and Controlled Companies ("**FOCCs**") which are essentially domestic companies, FEMA does not seem to allow investing in other Indian companies for non-cash consideration. Purely from a legal perspective, FOCCs should be allowed here subject to meeting Company law norms and FDI conditions.

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Even in the context of valuation of securities, these two statutes prescribe different set of pricing norms. While Company law requires valuation report from registered valuer under Registered Valuer Rules[11], the same needs to be issued by chartered accountant / SEBI registered Merchant Banker or practising Cost Accountant (or investment banker outside India in case of swap of equity instruments) under FEMA. Notably, there are separate set of valuation norms to be followed under tax laws also. These conflicts in the context of valuation vis-a-vis transfer/issue of shares, which impose enormous needless compliance burden with a little benefit from regulatory standpoint and sometimes, prone to litigation, needs appropriate resolution.

CONCLUSION:

It is apparent that Company law and FEMA do not go hand in hand in the aforesaid areas. This complex interrelation between them highlights the pressing need for streamlined alignment and clarity within the regulatory frameworks particularly, FEMA needs an immediate reconciliation in line with the basic provisions of Company law (as discussed above). From the perspective of determining legal ownership over any investments and/or to attach any entitlement / liability arising out of any applicable law or investment related agreements, an absolute clarity about date of issue or transfer of securities is very essential. Hence, it is of utmost importance that the Government / RBI address these anomalies by issuing necessary clarifications and/or make necessary amendments under FEMA.

– Chandrashekar K and Kishore Joshi

You can direct your queries or comments to the authors.

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[1] https://e-book.icsi.edu/default.aspx

[2] https://e-book.icsi.edu/default.aspx

[3] https://indiankanoon.org/doc/649631/

[4] https://e-book.icsi.edu/default.aspx

[5] https://incometaxindia.gov.in/Documents/Provisions%20for%20NR/FEM-Non-debt-Instruments-Rules-2019.htm

[6] https://www.rbi.org.in/Scripts/NotificationUser.aspx?Id=11723&Mode=0

[7] https://dpiit.gov.in/sites/default/files/FDI-PolicyCircular-2020-29October2020_0.pdf

[8] https://rbi.org.in/Scripts/BS_FemaNotifications.aspx?Id=174

[9] https://www.rbi.org.in/Scripts/NotificationUser.aspx?Id=11161&Mode=0

[10] Form FC-TRS which was launched on e-Biz portal w.e.f. Feb 08, 2016 vide https://www.rbi.org.in/commonman/English/Scripts/PressReleases.aspx?Id=1673 and subsequently, launched under FIRMS Portal w.e.f. Sept 1, 2018 vide https://firms.rbi.org.in/firms/faces/pages/login.xhtml

[11] https://www.mca.gov.in/ Ministry/pdf/ Companies_Registered _Valuers_Rules_2017.pdf

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