FOREIGN EXCHANGE REGULATIONS

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Need for Exchange Control

The need for exchange control does not requirs any emphasis, especially for a developing country like India. Even advanced countries like Britain and France have been forced to resort to exchange control to protect their economy. The preamble to the Foreign Exchange Regulation Act, 1947 (hereinafter referred to as "the Act") states that

> it is expedient in the economic and financial interests of India to provide for the regulation of certain payments, dealings in foreign exchange and securities and the import and export of currency and bullion.

Foreign exchange is largely earned by a country by means of exports of commodities and services from that country. Imports of goods and services by that country are to be paid for in foreign exchange (and not in the national currency of the importing country) except to the extent they are financed by credits, which in any event have to be repaid. Therefore, it is very much important for a country to conserve foreign exchange and ensure that all that hard-earned foreign exchange comes into its control and is wisely utilised in the best interests of the country. Conservation of precious foreign exchange is even more vital for a developing country like ours to pay for the import of machinery and technical know-how to build up a strong industrial base. Only countries with a strong favourable balance of trade and accumulated balances of gold and foreign exchange can afford to do away with exchange control.

It may not be out of place to point out that the *International Monetary Fund*, which requires that no member country shall, without the approval of the *Fund*, impose restrictions on the making of payments and transfers for current international transactions (*vide* Article VIII section 2 of the Articles of Agreement of the *Fund*) permits members to maintain and adapt to changing circumstances restrictions on payments and transfers for current international transanctions (*vide* Article XIV section 2 *ibid*). As a member of the *Fund* on the level of the restrictions maintained on exchange transactions.

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Introduction of Exchange Control in India

Exchange control in India is exercised through the Foreign Exchange Regulation Act, 1947 which came into force on 25th March 1947. Previously exchange control was exercised through certain provisions in the Defence of India Rules, 1939. The Act as originally enacted was modelled largely on the lines of the Exchange Control, Act, 1947 of the Britain and has been amended from time to time. The Act empowers the Reserve Bank and the Central government to secure that foreign exchange earned by exports or otherwise is properly accounted for and realised. It also authrises the control of acquisition and holding of foreign exchange in any form and making of payments in foreign exchange. Both the Government and the Reserve Bank issue notifications for the above purposes. The Act empowers the Central government to make Rules.[1] The Bank is also empowered under under *Section* 20(3) of the Act, to give directions to banks, travel agents and others. The Act, together with the rules made, and notifications issued thereunder and directions given by the Bank, constitutes the law of exchange control in India. For the convenience of the public, the Bank has published a manual, known as the *Exchange Control Manual*. The *Manual* contains a print of the Act, rules and notifications and also the directions issued by the Bank arranged subject-wise.

General Principles of Control

It is important to note that the regulaions under the Act are based on residence of the parties rather than on nationality. Whether certain provisions of the Act are applicable or not to a particular transaction would depend in general upon whether the transaction is entered into by or with a person "resident" in or outside India.[2] From the point of view of companies in India having branches outside the country, *clauses* (*d*) and (*e*) of sub-section (1) of *Section* 20 of the Act are very much material. A branch is treated as being resident in the country in which it is located and passing entries in favour of the branch are treated as creating a right in favour of a non-resident, for the purposes of exchange control. These provisions are necessary as otherwise persons will be able to get over the restrictions of the control by entering into transactions with foreign branches and thereby take funds out of the country. Precise rules have not been and cannot be laid down for determining whether a person is resident in India or not. Paragraph 3 of *Section* II of the *Exchange Control Manual* indicates some guidelines. Offices and branches of a company in India

1. *Section* 27 *Foreign Exchange Regulation Act*, 1947.
2. *Ss*. 4, 5, 6 etc. *Ibid*.

whether Indian or foreign are resident in India and offices and branches outside India of a company, whether Indian or foerign, are resident outside India for the purposes of exchange control.

The Act has extra-territorial application. Under *Section* 1(2) of the Act, all transactions made by Indian nationals and corporations (including their branches and agencies) incorporated in the India are governed by the Act. The term "foreign exchange" includes foreign currency, deposits and balances payable in foreign currency and foreign securities.

Bearing in mind the above general observations we may now notice the exchange control Regulations regulating private enterprise. For convenience, the regulatory provisions may be considered under certain specific headings.

Investments in India by Foreign Companies

Official policy in India is to encourage the inflow of foreign investments, consistent with the objectives of national economic policy. In principle the entry of foreign investment is encouraged in the field of manufacturing and in industries for which adequate capacity does not exist in the country but ordinarily investment in trading and financial enterprises is not permitted.

The *Industrial Policy Resolution* of 1948 recognised that participation of foreign capital and enterprise, particularly as regards industrial techniques and knowledge, would be of value for the rapid industrialisation of the country. However, it was necessary that the conditions under which foreign capital could participate in Indian industry should be carefully regulated in the national interest. As a rule, the major interest in ownership and effective control would normally be in Indian hands though provision was made for special cases in a manner calculated to serve the national interest.

Foreign investment policy was further amplified in 1949. Foreign capital was recognised as an important supplement to domestic savings for the development of the country and for securing scientific, technical and industrial know-how. Foreign enterprise was assured non-discriminatory treatment on par with domestic enterprise in regard to industrial policy requirements, facilities for the repatriation of profits and capital as well as payment of fair compensation in the event of compulsory acquisition of industrial units by the state. Although as a rule the major ownership and effective control of undertakings was to be in Indian hands, it was recognised that there could not be a hard and fast rule in this matter.

Government would not object to foreign capital having control of a concern for a limited period if it was found to be in the national interest and each individual case would be dealt with on its merits.

In the mid-fifties when industrialisation gathered momentum with the launching of the *Second Five Year Plan,* there was a sizeable increase in technical collaboration arrangements. During this phase India's sterling balances provided the necessary foreign exchange for the import of machinery and equipment. Later, towards the close of the fifties, with increasing foreign exchange stringency, minority foreign capital participation gained acceptance ; foreign enterprise took to equity participation to provide the foreign exchange component for the import of machinery and equipment and some collaborators also accepted equity participation *in lieu* of totalties and technical fees. The government extended a number of tax concessions favouring foreign enterprises and streamlined industrial licensing procedures to avoid delays in approvals of foreign collaboration. The setting up of the *Indian Investment Centre* in 1961 is also a systematic and sustained effort to bring together Indian and foreign entrepreneurs.

While all proposals for foreign collaboration require the prior approval of the government, there are no rigid criteria laid down for screening collaboration arrangements and each proposal is considered on merits having regard to plan priorities, the existing capacity in the country and future requirements. The normal policy of the government is to restrict foreign collaboration to those cases which bring technical know-how into the country, such as is not adequately available indigenously for developing new lines of production or where domestic capital is inadequate or not forthcoming. A foreign collabaration project is also considered favourably if it assists in reducing the pressure on the balance of payments by effecting a saving of foreign exchange through import substitution direct-ly by earning foreign exchange through exports.

In terms of *clouse* (*b*) of *Section* 13(1) of the Act, transferring any security or creating any interest in a security in favour of a non-resident, and in terms of *clause* (*d*) of the said section, issuing an Indian security to a non-resident, requires the Reserve Bank's approval.[3] Therefore, allotment of shares and debentures in an Indian company to a non-resident is controlled. Such a restriction is in the national interest. First, it would be desirable to avoid control by foreign companies of the vital sectors of the national economy. The alarm now expressed at the predominance of American companies in certain vital sectors of the European economy is well known. Secondly, the foreign companies may

3. The term "security", as defined in section 2 (*k*) of the Act, covers shares, stocks, bonds, debentures and debenture stock.

direct their investments to certain sectors of the national economy to the detriment of national companies which sectors can well be served by national companies. The predominance of foreign companies in the production and marketing of consumer articles like cosmetics, toilet articles, pharmaceuticals *etc.* in India hindering the growth of national industry is a sad fact.

Section 18 (3) of the Act prohibits transfer of business from the control of residents to non-residents without the Reserve Bank's approval. *Section* 18(3A) provides that transfer between two non-residents of an interest in a business in India requires the Bank's approval. *Section* 18(3B) prohibits the transfer to or creation of an interest in favour of a non-national of any business in India by a resident, without the Bank's approval. These restrictions are necessary in the national interest.

Opening of Branches in India by Foreign Companies

The Act does not *per se* place any restrictions on the opening of branches in India by foreign compantes. However, if a branch is opened without the Reserve Bank's approval, remittance facilities under the Act may not be allowed by the Bank in respect of that branch. Therefore, permission of the Bank should be obtained for opening a branch in India.

Although foreigner residents in India as also foreign and foreign controlled firms and companies in India are permitted to maintain bank accounts and operate them in the same manner as other residents of India, a certain amount are opened and operated upon has been found to be necessary. This is being done by asking the account holders in such category—foreign nationals resident in India, branches in India of foreign firms, companies or other organisations and companies controlled by non-residents, to file with the Reserve Bank an application by which it is brought to the notice of the account holders that it is illegal for them to provide any foreign exchange to other residents against reimbursement provided locally.[4]

Investments Outside India by Indian Companies

An Indian company cannot make investments outside India without the approval of the Reserve Bank. In the first instance it will amount to making a payment to a non-resident and thus attract *Section* 5(1) (*a*) of the Act. Secondly, it may amount to acquiring a foreign security and attract the provisions of *Section* 13(1)(*c*) if the investment is in the form of shares or debentures. Investments outside India by Indian companies are now being permitted by government as a part of joint ventures abroad. The

4. *Paragraph 1 to 3 of Section XXII of the Manuai.*

investments are generally required to be in the form of plant and machinery manufactured in India and limited to the value thereof. This provides a welcome outlet for the indigenous machinery industry. Foreign investments, though prejudicial to the country's interests from the short term point of view, could, in the long run be in its interests as income from the investments would augment the country's foreign exchange resources.

Opening of Branches Outside India by Indian Companies

The position is similar to opening of branches in India by foreign companies. Though there is no formal prohibition on opening of foreign branches, permission of the Reserve Bank would be necessary as opening of a foreign branch would involve remittances from India, which remittances would require the Bank's approval. If approval is not taken for opening a foreign branch, the Bank may not allow remittance facilities in respect of that brach.

Employment of Foreign Personnel by Companies in India

As regards employment of foreign personnel, paragraph 13 of *Section* V of the *Exchange Control Manual* states that prior sanction of the Bank must be obtained for the engagement of foreign nationals to work in India by persons resident in India. Therefore, approval of the Bank to be obtained for engaging foreign nationals in order to facilitate them to make remittances to their homes.

Special Restriction on Foreign Companies Carrying on Business in India

The Act imposes certain special restrictions on foreign companies functioning in India. These are contained in *Section* 18(4) and *Section* 18A. The former restricts giving of loans by a person resident in India to a Company (other than a banking company) which is controlled by non-residents. The Bank has, however, permitted banks (which are authorised dealers in foreign exchange) to grant loans and over-drafts to foreign controlled companies provided they are secured.[5]

Section 18A has been recently enacted and is intended to curb floatation of agencies in India by foreign companies. It provides that no company which is incorporated outside India or which is controlled by non-residents or a branch of such foreign company shall accept appointment as (*a*) agent in India in respect of trading or commercial transactions or (*b*) as technical or management adviser in India, except with the approval of the Central government or the Reserve Bank. This new section reflects the general policy of the government to restrict trading and commercial

5. *Vide paragraph 4(ii) of section XXVII of the Exchange Control Manual.*

activities in India of foreign companies. The Reserve Bank has, however, by a notification, permitted agencies of airlines, steamship companies and shipping and clearing agents to accept appointment as agents for incidental matters.

Restrictions on the Issue of Shares and Securities by Companies

The Act places several restrictions on the issue of shares by companies. By reason of *Section* 15 of the Act read with the notification issued thereunder, issue of bearer securites without the approval of the Reserve Bank is prohibited. The reason for this restriction is clear. Exchange control restricts the holding of securities by non-residents and transfers to non-residents. Unless the ownership of the securities is known, which will not be in the case of bearer securities, control cannot be exercised over the securities. Apart from the exchange control angle, the question of tax evasion is also to be considered.

Certain companies whose shares are quoted also on the *London Stock Exchange* are permitted to maintain an additional register of share-holders in London popularly described as the *London Register*, in addition to a register in India. Transfers between the two share-registers are regulated. *Section* 13(1)(*c*) of the Act prohibits transfers from an Indian register to a foreign register and *Section* 13(4)(*c*) from a foreign register to an Indian register, without the approval of the Bank. This is to regulate sale and purchase of securities by residents.

Section 13(4)(*b*) of the Act restricts entering in a register an address outside India except by way of substitution of an address in the same country. This is to regulate share-transfers by and to non-residents.

Control Regarding Foreign Companies Controlled by Residents

Sub-sections (1) and (2) of *Section* 18 of the Foreign Exchange Regulation Act deal with the foreign companies controlled by persons resident in India. Certain companies in India have subsidiary companies abroad controlled by them. There are also certain companies in which Indian residents are major share-holders or directors, whereby such companies are controlled by persons or companies resident in India. These foreign companies often accumulate large balances which are retained abroad instead of being repatriated to this country. They also do not declare dividends with the result the profits are not available to this country. With a view to ensure that the profits made by these Indian controlled companies are repatriated to this country, sub-sections (1) and (2) of *Section* 18 of the Act confer certain powers on the Central government and the Reserve

Bank. Sub-section (1) provides that a person resident in India should comply with the requirements that may be served on him by the Central government or the Reserve Bank in relation to such foreign companies. The requirements are set out in sub-section (2). They are furnishing particulars as to the assets and business of the foreign company, sale of foreign exchange to which the foreign company is entitled, declaration of dividends, realisation of assets of the foreign company and refraining from selling its securities. By means of these provisions it is possible to ensure that this country get the benefit of the profits accrued out of investments made abroad by persons resident in this country.

Export by Companies

The relevant provisions are *Section* 12 of the Act, Central government's *notification* dated 4th August 1967 issued thereunder and the Foreign Exchange Regulations Rules made by the Central government. The combined effect of these provisions is as follows :

Any person making an export of goods from India has to furnish to the Customs a declaration that the amount representing the full export value of the goods has been or shall within the prescribed period be paid in the prescribed manner. The prescribed period under *rule* 6 is six months from the date of shipment of the goods. The period can, however, be extended with the permission of Reserve Bank. As regards the manner of payment of the export value, the same is indicated in the *second schedule* to the said rules. Stated broadly, in respect of export of goods to convertible accont countries *i.e.* countries outside the sterling areas and countries other than countries with which the government has bilateral accounts, *i.e.* rupee payment accounts such as East European countries *etc.*, the payment for the exports has to be made in the currency of any other country in the group or in convertible sterling. Exports to sterlings areas countries can be paid for in sterling and exports to bilateral account of a bank in the country of import. Export to other countries will have to be paid for in any convertible currency.

These provisions have been introduced with a view to ensure that hard currencies of the countries to which exports have been made are obtained by this country. The provisions regarding the declaration of full export value is a device to check the common evil of undervaluation of exports, and building up of secret foreign balances. The other provisions of *Section* 12 of the Act ensure that the exporter does not do anything which may in any manner affect the realisation of the export proceeds. We may in this connection notice also *Section* 10 of the Act which provides that no

person who has a right to receive foreign exchange shall do anything which will have the effect of securing either delay in the receipt of foreign exchange or in the foreign exchange ceasing to be receivable by him. These provisions are aimed at securing that the full export value of the exported goods from this country is received by the country. It may be mentioned that in terms of *Section* 4 of the Act all foreign exchange can be received only through a bank authorised by the Reserve Bank and it will not be in order for the company to receive the foreign exchange directly.

General

There are certain other provisions in the Act which might be of special interest to companies. In terms of *Section* 4 of the Act, as pointed out above, no person resident in India, other than an authorised dealer, can buy or otherwise acquire any foreign exchange, except with the permission of the Reserve Bank. In view of this an Indian company cannot, except with the permission of the Reserve Bank, open an account in a foreign country. However, by reason of the *notification* dated 8th July 1947 issued by the Reserve Bank under *Section* 4(1) of the Act, this restriction does not apply to the maintenance and operation of a foreign currency account by a person who is not domiciled in India. In view of this a foreign company, though resident in India, would be exempted from this prohibition under *Section* 4(1) and can open and operate foreign currency accounts. *Section* 5 of the Act deals with the restrictions of payment to non-residents. A company resident in India should not make any payments to non-resident out of the money held by it abroad. However, the Bank's *notification* dated 30th July 1953 relaxes this condition and a company resident in India may make payments out of its foreign currency account provided the account had been in existence prior to 8th July 1947 and payments are made out of the balance held on that date. The date 8th July 1947 is significant as it was the date on which exchange control was introduced with reference to the sterling area countries also.

Conclusion

It will be seen from the above that the restrictions contained in the Foreign Exchange Regulation Act, 1947 are reasonable restrictions enacted in the interest of the country. These restrictions cannot be done away with till such time as the balance of payments position of the country improves and the country has abundant foreign exchange reserves. There have been no complaints about the enforcement of the regulations except perhaps in

the matter of 'P' forms. In view of the large number of branches that have been opened by the *Exchauge Control Department* of the Reserve Bank and in view of the delegation of power to authorised dealers, decisions relating to exchange control are taken very quickly and do not, as a rule, cause any hardship to parties. There have been very few cases of parties having gone to court inspite of the existence of the statute for over twenty years. This itself is conclusive proof of the fact that the regulations are reasonable and are being properly exercised.