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## ANALYSIS OF RECENT COMPOUNDING ORDERS

Bhaumik Goda | Saumya Sheth  
Chartered Accountants

Here is an analysis of some interesting compounding orders passed by the Reserve Bank of India in the month of December, 2019 and uploaded on the website<sup>1</sup>. This article refers mainly to the regulatory provisions as existing at the time of offence. Changes in regulatory provisions are noted in the comments section.

### FOREIGN DIRECT INVESTMENT (FDI)

#### A. Utkarsh CoreInvest Ltd.

**Date of order: 18<sup>th</sup> November, 2019**

**Regulation: FEMA 20/2000-RB [Foreign Exchange Management (Transfer or Issue of Security by a Person Resident Outside India) Regulations, 2000] and FEMA 20(R)/2017 (dated 7<sup>th</sup> November, 2017)**

#### ISSUE

FDI in Indian company engaged in business of investing in other companies and taking on record transfer of shares of an Indian company between two non-residents.

#### FACTS

##### Issue 1

- (i) The applicant company was engaged in the business of micro finance.
- (ii) Subsequently, it was issued license to set up a small finance bank wherein one of the conditions stipulated that the applicant company should be registered as an NBFC-CIC after transfer of its micro-finance business to the bank.

(iii) Accordingly, the applicant company applied to RBI for registering itself as an NBFC-CIC in December, 2016 and incorporated a subsidiary company to which it transferred the micro-finance business in January, 2017.

(iv) At the time of filing its application for license to set up a small finance bank, the applicant company had foreign shareholding of around 84.1%. In order to bring the foreign shareholding below 50%, the applicant company raised equity capital (by way of rights issue) which was offered to both resident and non-resident shareholders in November, 2017. The applicant company received FDI amounting to Rs. 28,68,95,310 at the same time which was not permissible under the extant FEMA 20(R).

(v) Subsequently, in March, 2018, FDI up to 100% under automatic route was allowed in investing companies registered as NBFCs with RBI.

## Issue 2

(a) In August, 2017, International Finance Corporation (IFC), a non-resident entity, had transferred 42,69,726 shares of the applicant company amounting to Rs. 55,50,64,380, to another non-resident entity which was recorded in the books of the applicant company without obtaining prior approval of the Government.

(b) The Government of India, MoF, DEA, while according its approval for another transaction in October, 2018 which involved share transfer between two non-resident entities had, vide its letter dated 22<sup>nd</sup> October, 2018, advised the applicant company to approach RBI for compounding for 'past foreign investments made in UMFL, including share transfers among non-residents, without GoI approval'.

## Regulatory provisions

Regulation 16(B)(5) of FEMA 20(R) in November, 2017 states that '*Foreign investment into an Indian company, engaged only in the activity of investing in the capital of other Indian company/ies, will require prior approval of the Government. A core investment company (CIC) will have to additionally follow the Reserve Bank's regulatory framework for CICs*'.

The above regulation was amended in March, 2018 which allowed foreign investment up to 100% under automatic route in investing companies registered as NBFCs with RBI.

Regulation 4 of the erstwhile FEMA 20, which stated that '*Save as otherwise provided in the Act, or rules or regulations made thereunder, an Indian entity shall not issue any security to a person resident outside India or shall not record in its books any transfer of security from or to such person.*'

## CONTRAVENTION

Nature of default	Amount involved (in INR)	Time period of default
Receiving FDI in Indian company which is engaged in investing in capital of other companies	Rs. 28,68,95,310	Seven months approx.

Taking on record share transfer between two non-residents when foreign investment itself was not permitted	Rs. 55,50,64,380	
<b>Total</b>	<b>Rs. 84,19,59,690</b>	

### Compounding penalty

A compounding penalty of Rs. 43,09,797 was levied.

### Comments

It is interesting to note that generally transfer of shares between two non-residents is not subject to any reporting requirement by the Indian company. Form FC-TRS regarding reporting transfer of shares of an Indian company is required to be filed only when either the transferor or the transferee is an Indian resident. Thus, any transfer of shares between resident to non-resident or vice versa is required to be reported in Form FC-TRS but not any transfer of shares between two non-residents.

However, where FDI itself is not permitted under the 100% automatic route and is subject to prior approval of the Government, any transfer of shares between two non-residents would also be subject to prior approval. Hence, Indian companies engaged in sectors where prior approval of Government is required should be cautious and ensure that any transfer of shares between two non-residents is undertaken only after obtaining prior approval of Government.

### B. M/s Star Health and Allied Insurance Co. Ltd.

**Date of order: 29<sup>th</sup> November, 2019**

**Regulation: FEMA 20(R)/2017 [Foreign Exchange Management (Transfer or Issue of Security by a Person Resident Outside India) Regulations, 2017]**

### ISSUE

Delay in allotment of shares within 60 days of receipt of share capital.

### FACTS

- (i) Applicant company is engaged in the business of non-life insurance.
- (ii) It received FDI from two Mauritian companies amounting to Rs. 30,50,00,079 in December, 2018.
- (iii) Shares were allotted by the applicant company to the above shareholders after a delay of three months and ten days (approximately) beyond the stipulated time of 60 days from the date of receipt of the consideration.

**Regulatory provision**

Paragraph 2(2) of Schedule I to Notification No. FEMA 20(R)/2017-RB, states that capital instruments shall be issued to the person resident outside India making such investment within 60 days from the date of receipt of the consideration.

**Contravention**

The amount of contravention is Rs 30,50,00,079 and the period of contravention three months and ten days.

**Compounding penalty**

A compounding penalty of Rs. 15,75,000 was levied.

**Comments**

The above order highlights the fact that RBI is taking a serious view of contraventions relating to delay in allotment of shares to foreign investors. Hence, it is absolutely critical that in respect of foreign investment, shares should be allotted within the prescribed period of 60 days as per erstwhile FEMA-20(R) and even under the new Foreign Exchange Management (Mode of Payment and Reporting of Non-Debt Instruments) Regulations, 2019 effective from 17<sup>th</sup> October, 2019.

**EXPORT OF GOODS AND SERVICES****C. H.F. Metal Art Private Limited and Azoy Bansal**

**Date of order: 5<sup>th</sup> November, 2019**

**Regulation: FEMA 23/2000-RB [Foreign Exchange Management (Export of Goods and Services) Regulations, 2000] and FEMA 23R/2015-RB [Foreign Exchange Management (Export of Goods and Services) Regulations, 2015]**

**ISSUE**

- (i) Failure to export goods within the prescribed period of one year from the date of receipt of advance.
- (ii) Failure to realise export proceeds within the stipulated time period.
- (iii) Contravention deemed to have been committed by director who was in charge of the company at the time of contravention.

**FACTS**

The applicant company is engaged in the business of minting and supply of precious metal coins and bars, as well as high quality medals, gifts and promotional items in non-precious metals.

The company received certain export advances between January, 2008 and July, 2011 amounting to Rs. 6,30,79,984 but was unable to make exports within the prescribed time limit. However, the company has adjusted the export advances against subsequent exports made during the period from August, 2013 to June, 2014.

The company could not realise export proceeds against certain exports amounting to Rs 10,58,50,346 within the prescribed time period 2014-2018.

### Regulatory provisions

Regulation 16 of Notification No. FEMA 23/2000- RB, where an exporter receives advance payment (with or without interest) from a buyer outside India, the exporter shall be under an obligation to ensure that the shipment of goods is made within one year from the date of receipt of advance payment.

Regulation 9 of Notification No. FEMA 23/2000- RB and FEMA 23(R), the amount representing the full export value of goods or software exported shall be realised and repatriated to India within nine months from the date of export.

Section 42(1) of FEMA states that, *'Where a person committing a contravention of any of the provisions of this Act or of any rule, direction or order made thereunder is a company, every person who, at the time the contravention was committed, was in charge of, and was responsible to, the company for the conduct of the business of the company as well as the company, shall be deemed to be guilty of the contravention and shall be liable to be proceeded against and punished accordingly'*.

### CONTRAVENTION

Relevant Provision	Nature of default	Amount involved (in INR)	Time period of default
Regulation 16 of FEMA 23/2000- RB	Failure to export the goods within a period of one year from the date of receipt of advance	Rs. 6,30,79,984	11 months to 4.6 years
Regulation 9 of FEMA 23/2000- RB & FEMA 23(R)	Failure to realise export proceeds within stipulated time period	Rs. 10,58,50,346	One day to seven months

Section 42(1) of FEMA	Being director of company which committed above contravention of FEMA	Rs. 16,89,30,330	11 months to 4.6 years and one day to seven months
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### Compounding penalty

Compounding penalty of Rs. 10,32,998 was levied on the company and Rs. 1,03,300 on the director personally.

### Comments

In the instant case, the company had committed contravention by not exporting goods against advance received within the prescribed time frame and also by not receiving payment for exports within the prescribed time. However, the director who was in charge of the company was also deemed to be guilty u/s 42(1) of FEMA and hence compounding penalties were levied both on the company as well as the director in respect of the contraventions. Accordingly, going forward, especially in cases of export of goods, it is advisable that directors of companies are extremely vigilant and ensure that their company adheres to the prescribed time lines failing which both the company as well as the directors would be personally liable for any contravention.

## BORROWING OR LENDING IN FOREIGN EXCHANGE

### D. M/s Tulsea Pictures Private Limited

**Date of order: 28<sup>th</sup> November, 2019**

**Regulation: FEMA 4/2000-RB [Foreign Exchange Management (Borrowing or Lending in Foreign Exchange) Regulations, 2000]**

### ISSUE

- (i) Borrowings from NRI without issuance of NCDs through public offer.
- (ii) Utilising borrowed funds for other than business purposes.

### FACTS

The applicant company appointed an NRI as one of the directors on its board.

The company raised a loan of Rs. 32,96,432 from the NRI director to meet its day-to-day expenses and other liabilities.

The loan in INR had been availed from the NRI without issuing non-convertible debentures (NCD) through public offer.

Out of the aforesaid amount, the applicant company had utilised Rs. 5,98,670 for paying the lease rentals for a residential premise taken for the NRI director and for meeting day-to-day expenses.

The company was granted permission to convert the loan amount into equity, subject to lender's consent and adherence to FDI / pricing norms for such conversion and reporting requirements.

The company allotted 55,056 equity shares to the director on 5<sup>th</sup> July, 2018 against the outstanding loan amount of Rs. 26,97,762.

### Regulatory provisions

Regulation 5(1)(i) of Notification No. FEMA 4/2000-RB *inter alia* states as under:

*'Subject to the provisions of sub-regulations (2) and (3), a company incorporated in India may borrow in rupees on repatriation or non- repatriation basis, from a non-resident Indian or a person of Indian origin resident outside India or an overseas corporate body (OCB), by way of investment in non-convertible debentures (NCDs) subject to the following conditions:*

*i. the issue of Non-convertible Debentures (NCDs) is made by public offer;...'*

Regulation 6 of Notification No. FEMA 4/2000-RB states that *no person resident in India who has borrowed in rupees from a person resident outside India shall use such borrowed funds for any purpose except in his own business.*

### CONTRAVENTION

Relevant Para of FEMA 4 Regulation	Nature of default	Amount involved (in INR)	Time period of default
Regulation 5(1)(i) of Notification No. FEMA 4/2000-RB	<b>Issue 1:</b> Borrowings from NRI without issuance of NCDs through public offer	<b>Issue 1:</b> Rs. 32,96,432	Approximately 7 years
Regulation 6 of Notification No. FEMA 4/2000-RB	<b>Issue 2:</b> Utilising borrowed funds for purpose other than business	<b>Issue 2:</b> Rs. 5,98,670	Approximately 7 years

### Compounding penalty

A compounding penalty of Rs. 1,29,213 was levied.

**Comments**

It is important to note that borrowings in INR by an Indian company from its NRI director, even though permissible under the Companies Act, 2013, is not permissible under FEMA regulations. Under FEMA, INR borrowings from NRIs are permitted only through issuance of NCDs made by public offer under both repatriation as well as non-repatriation route.

**OVERSEAS DIRECT INVESTMENT (ODI)****E. Ms Pratibha Agrawal**

**Date of order: 11<sup>th</sup> November, 2019**

**Regulation: FEMA 120/2004 [Foreign Exchange Management (Transfer or Issue of any Foreign Security) Regulations, 2004]**

**ISSUE**

Acquisition of foreign securities by way of gift from a person resident in India.

**FACTS**

The applicant was a resident individual and the spouse of a senior management employee of Sterlite Industries India Limited from 2001 to 2008.

The senior employee was offered 8,000 shares of Vedanta Resources Plc, London, in March, 2004 to be issued in two tranches. The first tranche of 4,000 shares was allotted in March, 2004 and second in February, 2005.

The consideration paid for the shares allotted in the second tranche was equivalent to face value, i.e., USD 400 (INR 17,532).

Out of the 4,000 shares of the second tranche, the senior employee gifted 3,000 to the applicant (Ms. Pratibha Agrawal) and, accordingly, share certificates for these 3,000 shares were issued in the name of the applicant.

**Regulatory provisions**

As per Regulation 22(1)(i), read with Regulation 3, a person resident in India being an individual may acquire foreign securities by way of gift only from a person resident outside India and not from another Indian resident.

**CONTRAVENTION**



<b>Relevant Para of FEMA 120 Regulation</b>	<b>Nature of default</b>	<b>Amount involved (in INR)</b>	<b>Time period of default</b>
Regulation 22(1)(i)	Acquisition of foreign securities by way of gift from a person resident in India	Rs. 22,49,232	Approximately 13 years

### **Compounding penalty**

Compounding penalty of Rs. 66,869 was levied.

### **Comments**

In view of the peculiar language of FEMA 120, it is advisable that appropriate care is taken in respect of gifts of shares of foreign companies between residents and non-residents. Under the existing provisions, an Indian resident can acquire shares by way of gift from only a non-resident and not from a resident.

### **F. Masibus Automation and Instrumentation Pvt. Ltd.**

**Date of order: 26<sup>th</sup> November, 2019**

**Regulation: FEMA 120/2004 [Foreign Exchange Management (Transfer or Issue of any Foreign Security) Regulations, 2004]**

### **ISSUES**

- (i) Sending remittances to overseas company without submitting Annual Performance Report (APR);
- (ii) Delay in submission of duly completed Part I of the Form ODI;
- (iii) Overseas investment undertaken by a method of funding not prescribed;
- (iv) Delayed receipt of proof of investment;
- (v) Delayed submission of APRs;
- (vi) Disinvestment from the overseas entity without obtaining fair valuation certificate prior to its divestment;
- (vii) Disinvestment undertaken from the overseas entity when it had outstanding loans;
- (viii) Disinvestment without prior approval of RBI when it was not eligible under the automatic route.

### **FACTS**

The applicant is engaged in the business of manufacturing of electrical equipment, wiring devices, fittings, etc.

The applicant remitted SGD 990 on 4<sup>th</sup> July, 2008 towards 99% stake in the overseas JV, viz., Masibus Automation and Instrumentation (Singapore) Pte. Ltd. in Singapore.

Subsequently, the applicant undertook ODI of SGD 5,000 on 4<sup>th</sup> July, 2008 by way of payment by the director of the applicant company in cash during his visit abroad.

The applicant had sent seven remittances aggregating SGD 52,000 in 2010-11 without submitting APR.

Further, the applicant submitted Part I of Form ODI with delay on 11<sup>th</sup> January, 2018 in respect of remittance of SGD 5,000 made through the director on 4<sup>th</sup> July, 2008.

Share certificate for the aforesaid remittance of SGD 990 made in July, 2008 was received with delay (i.e. beyond the prescribed period of six months under FEMA 120) on 8<sup>th</sup> September, 2014.

The applicant submitted APRs for the years ending 2009 to 2012 with delay on 12<sup>th</sup> January, 2018.

Disinvestment from the overseas entity was undertaken on 11<sup>th</sup> April, 2012 without obtaining fair valuation certificate and when it had outstanding loans.

Accordingly, as the applicant had outstanding loans, it was not eligible to undertake the disinvestment under the automatic route and should have sought prior approval of RBI before disinvestment.

### Regulatory provisions

Regulations 6(2)(iv), 6(2)(vi), 6(3), 15(i), 15(iii), 16(1)(iii), 16(1)(iv), 16(3) of FEMA 120.

### CONTRAVENTION

Relevant Para of FEMA 120 Regulation	Nature of default	Amount involved (in INR)	Time period of default
Regulation 6(2)(iv)	Making overseas remittances towards share capital without submitting APR of the overseas entity	Rs. 18,46,500	Five years
Regulation 6(2)(vi)	Overseas investment made through director in cash was treated as investment of Indian company, hence Indian company ought to have filed Part I of Form ODI for making remittance. There was delay in submission of Part I of the Form ODI in respect of the above investment	Rs. 1,60,600	4 <sup>th</sup> July, 2008 to 11 <sup>th</sup> January, 2018
Regulation 6(3)	Overseas investment undertaken through cash payment made by director is not a prescribed method of funding	Rs. 1,60,600	4 <sup>th</sup> July, 2008 to 13 <sup>th</sup> May, 2019

Regulation 15(i)	Proof of investment made in overseas entity should be received and filed with RBI within six months of making remittance. There was delay in providing share certificate to RBI in respect of overseas remittances made	Rs. 31,799	4 <sup>th</sup> July, 2008 to 8 <sup>th</sup> September, 2014
Regulation 15(iii)	APR of the overseas entity based on its audited accounts has to be filed annually on or before 31 <sup>st</sup> December. Applicant delayed submission of APR in respect of its overseas entity	Not applicable	1 <sup>st</sup> July, 2013 to 21 <sup>st</sup> September, 2018
Regulation 16(1)(iii)	Any divestment of overseas entity has to be undertaken at a price which is not less than its fair value as certified by CA / CPA based on last audited financials of overseas entity. In the instant case, applicant divested its overseas entity without obtaining its fair valuation certificate from CA / CPA	Rs. 31,799	11 <sup>th</sup> April, 2012 to 13 <sup>th</sup> May, 2019
Regulation 16(1)(iv)	An Indian party can undertake divestment of its overseas entity only when the overseas entity does not have any amount payable to Indian entity. In the instant case, the applicant had undertaken disinvestment of the overseas entity when it still had outstanding loans payable to it	Rs. 23,56,703	11 <sup>th</sup> April, 2012 to 13 <sup>th</sup> May, 2019
Regulation 16(3)	Indian entity wanting to divest its overseas entity which has any amount payable to it would need prior approval of RBI before undertaking divestment. In the instant case, the applicant undertook disinvestment without prior approval of RBI when not eligible under automatic route	Rs. 23,91,521	11 <sup>th</sup> April, 2012 to 13 <sup>th</sup> May, 2019

### Compounding penalty

Compounding penalty of Rs. 3,61,126 was levied.

### Comments

In view of numerous compliances prescribed under FEMA 120 in respect of overseas investments, it is essential that adequate care is taken by every Indian entity in respect of its overseas investment. Specific care should be taken to ensure that overseas investment by any Indian entity is routed only through Indian banking channels and not made in cash by any person visiting overseas.

Further, Regulation 16(1)(iv) of FEMA 120 states that at the time of divestment, the Indian party should not have any outstanding dues by way of dividend, technical know-how fees, royalty, consultancy, commission or other entitlements and / or export proceeds from the overseas JV or WOS. This includes any amount due, including loan payable by the overseas entity to an Indian entity. Hence, appropriate care should be taken to ensure that the overseas entity does not have any amount payable to an Indian entity at the time of its disinvestment.

### **G. Essar Steel India Ltd.**

**Date of order: 22<sup>nd</sup> November, 2019**

**Regulation: FEMA 120/2004 [Foreign Exchange Management (Transfer or Issue of any Foreign Security) Regulations, 2004]**

#### **ISSUES**

- (i) Effecting remittance without prior approval of RBI when the Indian party (IP) was under investigation by the Department of Revenue Intelligence (DRI);
- (ii) Delayed submission of APRs;
- (iii) Disinvestment without obtaining valuation.

#### **FACTS**

The applicant company set up a wholly-owned subsidiary (WOS), Essar Steel Overseas Ltd., in Mauritius by remitting USD 1 (INR 47) on 7<sup>th</sup> August, 2010.

Since the applicant company was under investigation by the DRI at the time of effecting the remittance, it was not eligible to make ODI under the automatic route.

The WOS was later liquidated on 9<sup>th</sup> March, 2012 and no valuation was done as required. The transactions were taken on record on 14<sup>th</sup> August, 2019.

Further, the applicant had reported Annual Performance Reports (APRs) for the accounting years 2011 and 2012 with a delay on 15<sup>th</sup> June, 2013 and 17<sup>th</sup> December, 2013.

#### **Regulatory provisions**

Regulation 6(2)(iii) of FEMA 120 provides that Overseas Direct Investment under automatic route is permitted in certain cases provided *'the Indian party is not on the Reserve Bank's exporters caution list / list of defaulters to the banking system circulated by the Reserve Bank, or under investigation by any investigation / enforcement agency or regulatory body.'*

Regulation 15(iii) of FEMA 120 states that, *'An Indian Party which has acquired foreign security in terms of the Regulation in Part I shall submit to the Reserve Bank, through the designated Authorised Dealer, every year on or before a specified date, an Annual Performance Report (APR) in Part III of Form ODI in respect of each JV or WOS outside India...'*. The specified date for filing APR currently is on or before 31<sup>st</sup> December every year.

Regulation 16(1) provides that an Indian party may disinvest to a person resident outside India subject to the following conditions:

- (iii) if the shares are not listed on the stock exchange and the shares are disinvested by a private arrangement, the share price is not less than the value certified by a Chartered Accountant / Certified Public Accountant as the fair value of the shares based on the latest audited financial statements of the JV / WOS.

### **CONTRAVENTION**

<b>Relevant Para of FEMA 120 Regulation</b>	<b>Nature of default</b>	<b>Amount involved (in INR)</b>	<b>Time period of default</b>
Regulation 6(2)(iii)	Effecting remittance and incorporating overseas entity under the automatic route without obtaining prior approval of RBI when the Indian Party (IP) was under investigation by DRI	Rs. 47	Seven years five months, to nine years and one month, approximately
Regulation 15(iii)	Delayed submission of APRs		
Regulation 16(1)	Disinvestment of the overseas entity without obtaining fair valuation certificate from CA / CPA at the time of disinvestment		

### **Compounding penalty**

A compounding penalty of Rs. 83 was levied.

### **Comments**

In the instant case, as the applicant was under investigation by DRI and the Enforcement Directorate (DoE) in Mumbai and Ahmedabad, the RBI had sought a No-Objection Certificate from the DoE before proceeding with the compounding application. However, as no reply was received from the DoE, RBI proceeded for the compounding without prejudice to any other action which may be taken by the authority under any other laws. Thus, RBI compounded the above contravention even though it did not receive any NOC from the DoE.

Besides, Indian entities wishing to make overseas investments should understand that if there is any investigation pending against them by any regulatory body or investigation agency, they cannot make an overseas investment under the automatic route and need to obtain prior approval of RBI before making such investment.