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FEMA Enforcement & Cross-Border Finance



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ED Adjudication, FDI Structuring, ECB Compliance, ODI Regulations & PMLA Intersection — The Complete Practitioner's Guide

Booklet V of VI — Indian Banking & Finance Sector Legal Series

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CHAPTER ONE

FEMA Contraventions: Adjudication by ED, Show-Cause Notice Strategy & Compounding with RBI

FEMA 1999 Enforcement, Adjudication Officer Jurisdiction, Penalty Computation, Appeal to Appellate Tribunal & High Court Writ Challenges to ED Action

A FEMA contravention notice from the Enforcement Directorate — the special police-like authority that enforces India's foreign exchange management law — is, for the sophisticated cross-border investor or large corporate group with overseas subsidiaries, one of the most commercially disruptive regulatory events possible. FEMA penalties can reach three times the sum involved in the contravention; the ED's power to arrest in cases of wilful FEMA violation (though rarely

invoked for genuine commercial transactions) creates personal risk for the company's promoters and directors; and an ongoing FEMA adjudication creates serious complications for any concurrent capital market transactions, M&A activity, or new foreign investment that requires RBI or FIPB approval. Managing the FEMA enforcement proceeding efficiently — resolving it through compounding wherever possible, contesting only where the legal merits strongly favour the company, and protecting concurrent commercial activity from the enforcement proceeding's contamination — is the central objective of FEMA enforcement defence.

1.1 FEMA's Civil Enforcement Architecture: ED vs RBI Jurisdiction

FEMA's enforcement is divided between two authorities with distinct but overlapping jurisdiction: the Reserve Bank of India (RBI), which has jurisdiction over "technical" contraventions — procedural violations such as delayed reporting, incomplete forms, or minor classification errors where there is no deliberate evasion — typically addressed through the compounding mechanism; and the Enforcement Directorate (ED), which has jurisdiction over "wilful" or major contraventions involving intentional violation, large-scale evasion, or contraventions that suggest money laundering — addressed through formal adjudication under Section 16 of FEMA with the possibility of arrest in cases of FEMA violations overlapping with PMLA predicate offences. The distinction between RBI compounding and ED adjudication is not always clear-cut — the same contravention (failure to bring back export proceeds within the prescribed period) may be addressed by either authority depending on the amount involved, the presence of intent, and whether the ED has independently commenced an investigation for related PMLA violations. For a company that receives both an RBI compounding notice and an ED show-cause notice for related contraventions, the strategic question is how to sequence the two proceedings — resolving the RBI compounding first typically demonstrates good-faith compliance and can be used in the ED proceeding to argue that the contravention was technical and has been remedied, undermining the ED's case for penalty beyond the compounded amount.

1.2 ED Show-Cause Notice: Response Strategy and Evidence Framework

An ED show-cause notice under Section 16(3) of FEMA — alleging specific contraventions and proposing a specified penalty — initiates the adjudication process before the Adjudicating Authority (an officer of the ED at Joint Director or above level). The show-cause response is the respondent's most important opportunity to establish the factual record and legal arguments that will be relied upon throughout the proceeding including any appeal to the Appellate Tribunal for Foreign Exchange (ATFE) and any subsequent High Court challenge. The response strategy for an ED FEMA show-cause notice must address: the jurisdictional basis for the ED's action (whether the contravention, even if proved, falls within ED's jurisdiction or is properly within RBI's compounding jurisdiction); the factual accuracy of the contravention alleged (specifically addressing the documentary evidence cited by the ED in the show-cause notice); the legal characterisation of the alleged contravention (whether the transaction actually constitutes

a FEMA violation, or is correctly characterised as an automatic-route permitted transaction that was merely not reported correctly); and the penalty quantum proportionality (demonstrating that the penalty proposed is disproportionate to the contravention's severity, particularly where no monetary loss to the Indian economy or no deliberate evasion is involved). The respondent's right to be personally heard before the Adjudicating Authority — guaranteed under Section 16(2) of FEMA — should always be exercised, since the personal hearing is the opportunity to present oral arguments on the legal and factual issues that cannot be fully addressed in the written response alone.

KEY PROVISION

Section 13, FEMA 1999: "If any person contravenes any provision of this Act, or contravenes any rule, regulation, notification, direction or order issued in exercise of the powers under this Act, or contravenes any condition subject to which an authorisation is issued by the Reserve Bank, he shall, upon adjudication, be liable to a penalty up to thrice the sum involved in such contravention where such amount is quantifiable, or up to two lakh rupees where the amount is not quantifiable, and where such contravention is a continuing one, further penalty which may extend to five thousand rupees for every day after the first day during which the contravention continues."

1.3 ATFE Appeals: Jurisdiction, Procedure and Stay Powers

The Appellate Tribunal for Foreign Exchange (ATFE), established under Section 18 of FEMA, hears appeals from adjudication orders of the ED's Adjudicating Authority. An appeal to ATFE must be filed within 45 days of receipt of the adjudication order (extendable by a further 45 days for sufficient cause), and the ATFE's jurisdiction is plenary — it can consider both the merits of the contravention finding and the proportionality of the penalty. The ATFE's stay powers are critical for managing the commercial impact of an adverse adjudication order: a party that has filed a ATFE appeal can apply for a stay of the penalty recovery while the appeal is pending, which prevents the ED from initiating recovery proceedings (including attachment of assets) during the pendency of the appeal. The ATFE stay application requires a deposit of a portion of the penalty amount — the ATFE has discretion on the deposit quantum, and practitioners typically negotiate for a 25-30 per cent deposit with the balance stayed pending the appeal outcome. High Court writ jurisdiction under Article 226 is available as an alternative to ATFE appeal where the adjudication order contains a jurisdictional error, a violation of natural justice, or raises a pure question of law — and the High Court's faster timeline for admission and interim relief (compared to the ATFE's often lengthy hearing schedule) makes the writ route strategically preferable for cases involving fundamental legal challenges to the ED's authority.

1.4 Arrest Under FEMA: Section 19 Powers and the Personal Risk Framework

Section 19 of FEMA empowers the Adjudicating Authority to authorise arrest of a person who has committed a FEMA contravention where the Adjudicating Authority has reason to believe

that the person is attempting to abscond or the contravention is of a serious nature. In practice, FEMA arrests are extremely rare for corporate FEMA contraventions — the ED reserves its arrest power for egregious cases involving deliberate and large-scale evasion, forged documents, or contraventions that constitute predicate offences for PMLA prosecution. However, where a FEMA contravention is accompanied by an ED PMLA investigation (for money laundering arising from the FEMA violation as a predicate offence), the PMLA's much broader arrest powers (Section 19 of PMLA, requiring only "reason to believe" that the person has been involved in money laundering) create a real personal risk for promoters and directors who are the subjects of concurrent FEMA and PMLA investigations. The practitioner advising a client facing concurrent FEMA and PMLA proceedings must: assess the overlap between the FEMA contravention and the PMLA predicate offence; implement personal protection measures (cooperation with the investigation, availability for examination, no foreign travel without informing the ED, and no asset transfers that could be characterised as evasion of attachment); and pursue expedited resolution of the FEMA contravention through compounding to remove the predicate offence basis for the PMLA proceeding.

FDI Structuring and Post-Investment Compliance: Downstream Investments, Pricing Guidelines & Reporting Obligations

FEMA 20R, FDI Policy, Sectoral Caps, Prohibited Sectors, Pricing Guidelines for Issue & Transfer, FC-GPR & FC-TRS Reporting

2.1 FDI Pricing Guidelines: The DCF Floor and Its Consequences

The pricing guidelines for issue of equity shares to foreign investors — under the Foreign Exchange Management (Non-Debt Instruments) Rules, 2019 (FEMA 20R) — require that shares issued to a foreign investor must be at a price not less than the fair value determined on a Discounted Cash Flow (DCF) basis for unlisted companies, or at market price (SEBI's minimum price formula) for listed companies. The DCF floor creates significant structuring complexity for cross-border investments in Indian companies: where a foreign PE investor is acquiring a stake in a loss-making or early-stage Indian company that has no positive DCF value (because its projected cash flows do not produce a positive NPV at the investor's hurdle rate), the DCF pricing requirement effectively prohibits the issuance of shares at a nominal value — the shares must be issued at the DCF fair value even if that value is above the investor's agreed acquisition price. Practitioners structuring FDI transactions for PE funds, strategic investors, and cross-border joint ventures must obtain the valuation analysis before the transaction is structured — not as a post-hoc formality — since a DCF valuation that produces an unexpectedly high floor price can require the investor to issue fewer shares for the same consideration (preserving the foreign investor's economic interest but reducing its equity percentage), or to restructure the instrument as a convertible debenture (which has different pricing rules) rather than equity.

2.2 Downstream Investment: The Indirect FDI Problem

Downstream investment — investment by an Indian company that has received foreign investment (a "company owned or controlled by foreign investors" under the FDI Policy) into another Indian company — is subject to the foreign investment norms applicable to the downstream investee company, treating the downstream investment as if it were direct foreign investment into the downstream entity. This "look-through" approach to downstream investment creates complex compliance challenges for Indian groups with foreign-invested holding companies: every investment by the Indian holding company (that has a foreign investor) into a new subsidiary, joint venture, or associate must be tested against the sectoral caps and conditions applicable to the downstream investee's activity. Where the downstream investee operates in a sector with a sub-100 per cent FDI cap (e.g., insurance — 74 per cent, defence —

74 per cent) or a restricted sector, the Indian holding company's downstream investment must comply with the relevant cap, the Indian holding company must itself qualify as an "Indian company" for the purpose of making the downstream investment (meaning its own beneficial ownership must be primarily Indian), and the downstream investment must be notified to the DPIIT in the prescribed form. For Gujarat-based corporate groups with complex holding structures involving foreign JV partners, Mauritius-route investments, or overseas listing vehicles, the downstream investment analysis is a mandatory element of any new group-level investment or corporate restructuring.

External Commercial Borrowings: Eligible Borrowers, End-Use Restrictions, All-in-Cost Ceilings & Hedging Mandates

RBI Master Direction on ECB 2019, ECB Framework, Track I/II/III, Minimum Maturity, Permitted & Negative End-Uses, Hedging Policy & ECB Reporting

3.1 ECB Framework: Tracks, Eligible Borrowers and Permitted Lenders

The RBI's Master Direction on External Commercial Borrowings, Trade Credits, Borrowings and Notes Issued Overseas (updated 2019 and periodically revised) establishes a three-track framework for ECB: Track I (medium-term foreign currency denominated ECB with a minimum average maturity of 3-5 years depending on the amount, for eligible borrowers in manufacturing, infrastructure, and specified services sectors); Track II (long-term foreign currency denominated ECB with a minimum average maturity of 10 years for all eligible borrowers); and Track III (Indian rupee-denominated ECB with a minimum average maturity of 3-5 years). The eligible borrower categories — companies, limited liability partnerships, real estate investment trusts (REITs), and infrastructure investment trusts (InvITs) in specified eligible sectors — do not include financial entities such as banks, NBFCs (with limited exceptions for ECBs for on-lending to specified sectors), and housing finance companies. For a Gujarat manufacturing company seeking to raise foreign currency borrowing for capacity expansion — a common requirement for mid-to-large industrial clients — the ECB route offers access to international credit markets at typically lower interest rates than domestic borrowing, but imposes compliance obligations that persist throughout the ECB's life: periodic ECB-2 reporting to authorised dealers, hedging requirements (for eligible entities with unhedged foreign currency exposure), end-use compliance monitoring, and all-in-cost ceiling compliance.

3.2 End-Use Restrictions: What ECB Proceeds Cannot Finance

The ECB framework's negative list of end-uses — activities for which ECB proceeds cannot be deployed — is one of the most practically significant compliance constraints for ECB borrowers, and violations of end-use restrictions are a common subject of ED FEMA enforcement action. Prohibited end-uses for ECBs under all tracks include: real estate activities (with limited exceptions for affordable housing and hotel infrastructure); investment in capital markets or equity investments; on-lending to entities for these prohibited purposes; working capital financing (for Track I ECBs below 10 years — longer-maturity ECBs have wider use permissions); and general corporate purposes (for Track I ECBs, which must specify a capital expenditure or infrastructure purpose). The end-use compliance obligation is ongoing — the ECB

borrower must maintain books demonstrating that proceeds were deployed for the specified permitted purpose, must produce end-use certificates from its statutory auditors on request by the RBI, and must immediately report to its authorised dealer if any proceeds are diverted from the permitted purpose. Practitioners advising companies on ECB structuring must review the proposed use of proceeds against the current negative list — which has been revised several times since 2019 — before the ECB loan agreement is entered into, since post-draw-down end-use changes require RBI approval that is not guaranteed.

Overseas Direct Investment: ODI Regulations, Round-Tripping Risks, Guarantee Structures & FEMA Compliance

FEMA ODI Rules 2022, Automatic Route Limits, Prohibited Sectors, ODI Reporting Obligations, Round-Tripping Structures & Pledge of ODI Shares

4.1 ODI Framework: The 2022 Overhaul and Its Implications

The Foreign Exchange Management (Overseas Investment) Rules and Regulations, 2022 — which came into effect on 22 August 2022, replacing the pre-existing ODI framework — represent the most comprehensive overhaul of India's outbound investment regulations in over a decade. The 2022 framework introduces: a cleaner distinction between Overseas Direct Investment (ODI — acquisition of 10 per cent or more equity in a foreign entity, with intent to establish lasting interest) and Overseas Portfolio Investment (OPI — equity holdings below 10 per cent without managerial intent); a revised automatic route limit of 400 per cent of net worth for ODI by Indian entities; stricter eligibility criteria for the ODI automatic route (the Indian entity must be profitable in the immediately preceding three financial years to qualify for automatic-route ODI above USD 1 billion); and expanded prohibited sectors for ODI (real estate, financial services businesses not complying with FATF standards, and entities in jurisdictions without adequate AML/CFT supervision). For Gujarat corporate groups with existing overseas subsidiaries — or planning new overseas joint ventures, step-down subsidiaries, or offshore holding structures for IP ownership, treasury operations, or global business headquarters — the 2022 framework's revised thresholds, reporting requirements, and prohibited sector restrictions require a comprehensive compliance review of all existing overseas investments and future investment plans.

4.2 Round-Tripping: The Structural Risk and Its Legal Consequences

Round-tripping — the flow of Indian-origin funds out of India through ODI and back into India as FDI, creating the appearance of foreign investment for the purpose of evading Indian regulatory requirements or obtaining benefits available only to foreign investors — is one of the most serious FEMA violations and a frequent target of ED investigation. The typical round-trip structure involves: Indian company investing in a Mauritius or Singapore intermediate holding company under the ODI framework; the intermediate entity then making a "foreign" investment back into India (or into a related Indian company) as FDI; and the FDI investment receiving tax treaty benefits, higher sectoral caps, or softer regulatory treatment than a direct Indian-to-Indian investment would receive. The ED's investigation of round-tripping structures relies on:

tracing the beneficial ownership of the foreign investing entity through beneficial ownership disclosure filings in Mauritius, Singapore, or other intermediate jurisdictions; analysing the economic substance of the intermediate entity (whether it has real offices, employees, and business activities beyond holding the Indian investment); and establishing the connection between the Indian-origin ODI and the subsequent FDI inflow. Practitioners structuring overseas investment vehicles for Indian clients must ensure genuine economic substance in the intermediate entities, maintain proper corporate governance and local presence in the intermediate jurisdiction, and document the legitimate business purpose for the overseas structure — not merely the tax or regulatory benefit that motivates the structure.

PMLA Intersection with FEMA: ED Dual Jurisdiction, Attachment Proceedings & Enforcement Appellate Tribunal

PMLA 2002, Proceeds of Crime, Provisional Attachment, Adjudication Before PMLA Adjudicating Authority, PMLA ATFE Appeals & High Court Challenge to Attachment

5.1 FEMA as PMLA Predicate Offence: The Dual Enforcement Risk

The Prevention of Money Laundering Act, 2002 (PMLA) — which criminalises money laundering (defined as knowingly dealing with the "proceeds of crime" from a "scheduled offence") — lists several FEMA violations as scheduled offences in Part B of the PMLA Schedule. Specifically: offences under Sections 13(1)(a) to (e) of FEMA (contraventions of FEMA provisions) are scheduled offences under the PMLA when the value involved exceeds Rs. 1 crore. This means that a FEMA contravention involving more than Rs. 1 crore — including an unauthorised FDI structure, an overdue ECB repayment, or an undisclosed ODI — not only exposes the company to FEMA penalty proceedings before the ED Adjudicating Authority, but also potentially to PMLA prosecution, provisional attachment of "proceeds of crime" by the ED under Section 5 of the PMLA, and arrest of the persons involved under Section 19 of PMLA. The consequences of PMLA attachment are far more commercially disruptive than FEMA penalty: the ED can provisionally attach any property (including the company's operating assets, bank accounts, and real estate) that it identifies as "proceeds of crime" — property acquired using funds that trace to the FEMA violation — without prior notice or hearing, with the attachment taking effect immediately upon the Authorised Officer's order and remaining in place for 150 days pending confirmation by the PMLA Adjudicating Authority.

5.2 Challenging PMLA Provisional Attachment: Section 8 Proceedings Before the Adjudicating Authority

The PMLA Adjudicating Authority — a quasi-judicial body established under Section 6 of PMLA — is the forum before which the ED must establish the legality of its provisional attachment order within 150 days of the provisional attachment. The Adjudicating Authority's confirmation order (which confirms the attachment for up to 365 days) can be challenged by the attached party in proceedings before the Authority under Section 8(2), where the attached party bears the burden of demonstrating that the attached property is not "proceeds of crime." The PMLA proceedings before the Adjudicating Authority are the primary forum for challenging the ED's attachment — the Adjudicating Authority has the power to confirm, vary, or set aside the provisional attachment, and a well-presented challenge that demonstrates that the attached

property was acquired from legitimate Indian-source funds (not from the FEMA contravention's proceeds) can result in the attachment being set aside before the matter reaches prosecution stage. Practitioners challenging PMLA attachments must: obtain the complete ED investigation report and attachment order from the Adjudicating Authority's registry; forensically trace the provenance of the attached property to demonstrate its acquisition from legitimate funds; and challenge the ED's "proceeds of crime" characterisation — demonstrating that there is no nexus between the FEMA contravention and the specific property attached is the most effective factual defence against a PMLA attachment confirmation.

LEADING CASE

Vijay Madanlal Choudhary v. Union of India (2022) 5 SCC 1: The Supreme Court's comprehensive ruling on the PMLA's constitutional validity upheld the Act's core provisions — twin conditions for bail, reverse burden of proof, and the wide definition of proceeds of crime — while clarifying that the PMLA Adjudicating Authority's proceedings are not criminal trials but civil proceedings for confiscation, and that the standard of proof is "preponderance of probabilities" rather than "beyond reasonable doubt." This ruling significantly affects PMLA defence strategy: the lower civil standard means that the ED need not prove its attachment case to the criminal standard, but the respondent's counter-evidence need only establish the property's legitimate origin on the balance of probabilities — a more achievable threshold than "beyond reasonable doubt" for sophisticated corporate respondents with documented financial records.

Compounding Proceedings: RBI Compounding Application, Computation of Compounding Amount & Settlement Strategy

FEMA Compounding Rules 2000, RBI Compounding Authority, Voluntary Disclosure vs ED Referral, Compounding Amount Formula & Post-Compounding Compliance Obligations

6.1 RBI Compounding: The Voluntary Compliance Mechanism

Compounding under FEMA — the mechanism by which a FEMA contravention is settled by payment of a specified amount to the RBI (or ED, where the ED has compounding authority) without formal adjudication — is the preferred resolution mechanism for technical FEMA violations that do not involve wilful evasion, money laundering, or national security concerns. The RBI's Compounding of Contraventions under FEMA, 1999 Rules, 2000 govern the compounding process: a person who has committed a FEMA contravention may voluntarily apply to the RBI's Compounding Authority for compounding, disclosing the nature, extent, and circumstances of the contravention; the Compounding Authority assesses the application and determines a compounding amount based on the prescribed formula; and upon payment of the compounding amount, the contravention is deemed to have been compounded and the person is immune from further FEMA proceedings for that specific contravention. The compounding mechanism's appeal is its finality: a compounded FEMA contravention cannot be re-opened by the ED for adjudication (unless the compounding application contained material misrepresentation), and the compounding order provides a clean regulatory record that is important for companies seeking fresh RBI approvals, ECB registrations, or FDI applications. Voluntary compounding — proactively applying to the RBI before the ED notices the contravention — typically results in a significantly lower compounding amount than compounding initiated after ED investigation, since the RBI's compounding formula applies discounts for voluntary disclosure and co-operation.

6.2 Compounding Amount Formula: Variables and Negotiating Range

The RBI's compounding amount formula — as set out in the Compounding Rules — computes the compounding amount as a percentage of the "amount involved in the contravention," subject to a minimum floor and a ceiling equal to the maximum FEMA penalty (three times the amount involved). The percentage applied depends on: the nature of the contravention (reporting delays attract a lower percentage than substantive violations of investment limits); the duration of the contravention (a one-year reporting delay is compounded at a lower rate than a five-year delay); the voluntary vs. ED-initiated nature of the application (voluntary applications receive a discount

in the compounding computation); and any aggravating factors (repeat contraventions, large quantum, multiple related contraventions). For a company that has accumulated multiple FEMA reporting violations over several years — a common situation for fast-growing companies that expanded overseas rapidly without dedicated FEMA compliance infrastructure — the aggregate compounding amount across all contraventions can be substantial, and the practitioner's role in preparing the compounding application includes: organising the contraventions into logical groups (to avoid each minor reporting error being assessed as a separate contravention); framing the narrative explanation in a way that emphasises good faith and systemic failure rather than deliberate evasion; and demonstrating the remediation steps already taken (implementation of FEMA compliance procedures, appointment of FEMA compliance counsel, completion of outstanding reporting filings).

Booklet V Complete Summary: FEMA enforcement, FDI structuring, ECB compliance, ODI management, and PMLA intersection represent the full spectrum of cross-border finance legal risk for India's most commercially active corporate clients. The ED's dual FEMA and PMLA jurisdiction — and the PMLA's attachment powers that can immobilise operating assets — make proactive FEMA compliance and early voluntary compounding the most cost-effective risk management strategy. FDI pricing guidelines, downstream investment look-through, ECB end-use restrictions, and ODI round-tripping risks are the transactional compliance obligations that demand specialist legal oversight at the transaction structuring stage — not after the ED notice arrives. The 2022 ODI framework overhaul requires comprehensive review of all existing overseas investment structures for Gujarat corporate groups with international presence.