Two litigations and a takeaway

The fact that the complexities of FEMA are used to dispute contractual obligations is a wake-up call for the simplification of the law

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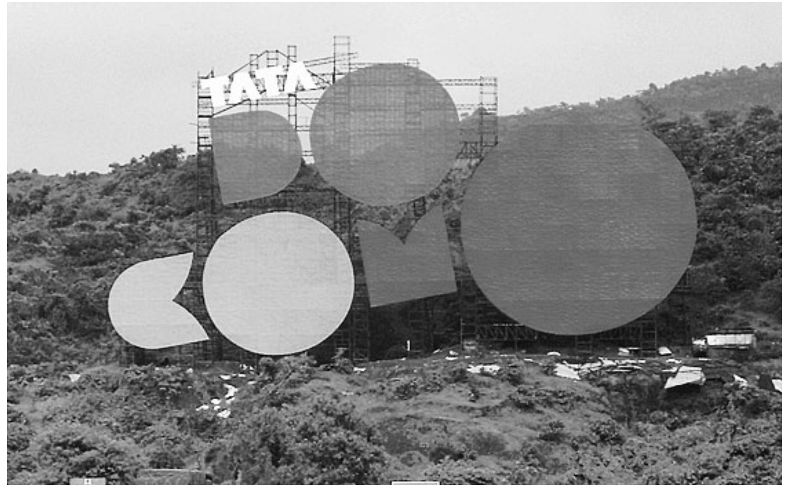
In an earlier article, "Why India needs a new FDI regime" (June 4, 2016), we pressed the need for simplifying the law governing foreign direct investment in India. We argued that the Foreign Exchange Management Act, 1999 (FEMA), the current law governing all foreign exchange transactions with Indian residents, creates artificial distortions between identical economic transactions and allows excessive discretion resulting in ad hoc administration. Two ongoing litigations involving foreign investors underscore this need. Pertinently, in both these litigations, neither party has denied the liability to pay the foreign investor. Despite this, FEMA and the maze of regulations issued under it pre-empt private parties from successfully enforcing their undisputed contractual rights.

The first is the Hubtown case involving a Dutch development bank's (Dutch Bank) investment in the Indian real estate sector. The Dutch Bank had invested in the equity of an Indian company (let's call it Vinca). Vinca, in turn, invested the money in rupee-denominated optionally convertible instruments of two other Indian companies (let's call these companies A and R). When A and R defaulted on the interest payment on the instruments, the debenture trustee for Vinca sued the guarantor of these instruments. The Bombay High Court held that FEMA disallowed foreign investors from investing in optionally convertible debt instruments. Since Vinca had used the money invested by the Dutch Bank for investing in optionally convertible debt instruments, the structure was violative of FEMA. Last month, the Supreme Court reversed the Bombay High Court order on the ground that the guarantee sought to be enforced was given to Vinca, an Indian entity. Therefore FEMA did not apply. It directed the Bombay High Court to dispose of the suit expeditiously and preferably within a year.

The Dutch Bank had made the investment in 2009-10, A and R defaulted in 2011, and the Supreme Court order was passed in 2016. Even if the high court allows the enforcement of the guarantee, it is not clear if the Dutch Bank will, as a shareholder of Vinca, be allowed to take back its earnings from Vinca without regulatory hurdles, as the Supreme Court order vaguely refers to an approval from the Reserve Bank of India (RBI) for such repatriation.

The second case, namely the dispute between Tata Teleservices and NTT Docomo, needs less of an introduction. In 2008, NTT Docomo acquired a 26 per cent stake in Tata Teleservices for about ₹12,740 crore at ₹117 per share. Briefly summarised, the agreement was that if certain revenue targets were not met, Docomo could "put" its shares on the Tatas at a pre-determined price equivalent to roughly 50 per cent of Docomo's acquisition cost. Thereafter, FEMA regulations were amended to provide that foreign investors could not exit by exercising a put option at a pre-fixed price. While Docomo obtained an arbitration award in its favour in 2015, it struggles to enforce the award under the shadow of the amended law.

In both these cases, no party denies the liability to pay but only contends that FEMA pre-empts them from making such payment to their foreign investors. Difficulty in recovery of capital invested in India, due to regulatory hurdles, does not augur well for the ease of doing business or any other ranking for the country. The fact that the complexities of FEMA are used to dispute contractual obligations, underscores the need to simplify the law.



LEGAL TANGLE **Docomo obtained an arbitration award in its dispute with Tata Teleservices, but it struggles to enforce it under the shadow of amended law**

The problems with FEMA, as a law, can be bunched into two broad categories. First, FEMA does not clarify the objective of the controls that it seeks to impose. Admitted that even globally, a consensus on the motivations for capital controls is missing. However, the capital controls imposed by FEMA seem to be mired in a mix of several motivations such as protectionism, currency volatility and systemic risk concerns. For instance, sectoral caps and norms such as local sourcing requirements are for protecting the domestic sector. On the other hand, quantitative limits on foreign investment in debt are motivated by multiple concerns relating to external vulnerabilities, over-reliance on foreign capital and overheating of the economy.

The multiplicity of objectives results in multiple restrictions being built in the law to achieve different objectives, and then additional restrictions are imposed to pre-empt people from subverting the main restrictions. The lack of clarity makes it difficult to gauge the effectiveness of the law, as there is no single intended outcome which can be used to gauge whether the restrictions are achieving their purpose.

Two, FEMA allows wide exercise of discretion by the RBI and the central government. In the absence of clear objectives for exercise of this discretion, it leads to a complete collapse of rule of law in its administration. It allows the administration to impose extensive ad hoc controls and centrally plan the allocation of foreign capital in the economy. Sudden restrictions on amounts that Indians are allowed to retain in their foreign currency accounts in India, and a sudden ban on foreign portfolio investment in local currency debt of certain tenure are two examples of overnight restrictions that FEMA permits.

Even as we debate the utility of capital controls as a tool of macroeconomic policy, thinking about the design of the law for imposing controls becomes imperative. First, permanent capital controls, if any, should be legislated only under parliamentary law. This is because delegating the power to impose capital controls on executive agencies, in the absence of a clear objective, is dangerous. Second, the law should allow flexibility to impose additional temporary controls with clearly articulated objectives. Third, the law must specify the nature of temporary controls that can be imposed, the objectives for imposing temporary controls, the priority for using different kinds of controls for addressing different exigencies, the due process to be followed for such imposition and an outer timeline when the controls will automatically lapse.

In thinking about the road map towards rationalisation of capital controls framework, a useful analogy can be drawn with the trajectory of foreign trade liberalisation. In the post-liberalisation period, our foreign trade regime has been simplified and all non-tariff barriers have been dismantled. The only instrument of control is the tariffs. It is time we harness similar thinking on the simplification and rationalisation of our capital controls framework.

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