

## INDIA'S FOREIGN EXCHANGE REGULATION: EVOLUTION, ENFORCEMENT, AND EMERGING LEGAL DOCTRINES UNDER FEMA

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### ABSTRACT

This research article critically examines the evolution, enforcement, and emerging legal doctrines of India's foreign exchange regulation framework, with a particular focus on the transition from the Foreign Exchange Regulation Act (FERA) to the Foreign Exchange Management Act (FEMA), 1999. The study aims to trace the shift from a control-oriented regime under FERA to a more liberalized, civil framework under FEMA, emphasizing regulatory modernization in the context of globalization, capital mobility, and compliance with international financial norms.

Using a doctrinal and analytical methodology, this study systematically reviews statutory provisions, delegated legislations, and institutional roles—primarily that of the Reserve Bank of India (RBI) and Authorized Dealers (ADs). It delves into the Foreign Exchange Management Rules governing current and capital account transactions and examines their significance within India's broader economic and legal frameworks.

The paper also explores the integration of anti-money laundering (AML) mechanisms within FEMA through compliance, supervisory, and technological frameworks, highlighting India's alignment with global AML standards. The enforcement mechanisms under the Directorate of Enforcement (ED), and their interface with the Prevention of Money Laundering Act (PMLA), are critically analyzed through doctrinal scrutiny and select case laws.

Key judgments such as *ED v. Hasan Ali Khan*, *Ketan Parekh v. Union of India*, and *J. Sekar v. Directorate of Enforcement* are studied to understand judicial interpretations on civil penalties, procedural fairness, and RBI's regulatory discretion. The findings underscore an evolving jurisprudence characterized by a balance between economic liberalization and regulatory vigilance.

The article concludes that while FEMA represents a paradigm shift from punitive control to facilitative regulation, emerging challenges in AML enforcement, judicial oversight, and regulatory clarity demand continuous legal adaptation to meet global compliance expectations and economic resilience.

### FOREIGN EXCHANGE REGULATION IN INDIA

#### OVERVIEW OF FOREIGN EXCHANGE REGULATIONS

India's foreign exchange regulatory framework has undergone a transformative evolution, shaped by shifting macroeconomic priorities,

global economic integration, and financial sector reforms. As Bimal Jalan observed, "India's economic policy since the 1990s represents a transition from control to regulation, reflecting a broader shift towards market-friendly governance."<sup>872</sup> This transformation is perhaps

<sup>872</sup>Bimal Jalan, *India's Economic Policy: Preparing for the Twenty-First Century* 88 (Penguin Books, New Delhi, 2001).

best exemplified by the legislative shift from the Foreign Exchange Regulation Act (FERA), 1973 to the Foreign Exchange Management Act (FEMA), 1999, which reoriented India's regulatory outlook from one of strict control to one of managerial facilitation and compliance.

FERA was designed as a stringent criminal statute that treated foreign exchange violations as offences, a reflection of the post-colonial fear of capital flight and foreign economic dominance.<sup>873</sup> However, recognizing the demands of liberalization and the increasing importance of capital mobility in the 1990s, FEMA was enacted as a civil law statute with an enabling character. As stated in the *Statement of Objects and Reasons* of FEMA: "The objective is to consolidate and amend the law relating to foreign exchange with the objective of facilitating external trade and payments and for promoting the orderly development and maintenance of foreign exchange market in India."<sup>874</sup>

This chapter undertakes a comprehensive analysis of FEMA, 1999—its objectives, structural framework, and institutional mechanisms. The central regulatory role of the Reserve Bank of India (RBI) is examined, particularly in its supervisory capacity over capital account and current account transactions.<sup>875</sup> Equally significant is the function of Authorized Dealers (ADs), who act as intermediaries facilitating forex transactions under RBI's directives.<sup>876</sup>

Another critical dimension of India's foreign exchange governance is the interplay between FEMA and the Prevention of Money Laundering Act (PMLA), 2002. As observed in academic commentary, "The integration of AML compliance into FEMA operations reflects a global consensus on the need for financial

integrity in cross-border transactions."<sup>877</sup> In this context, India's obligations under international standards such as those issued by the Financial Action Task Force (FATF) are highly relevant.<sup>878</sup> The AML-CFT (Combating the Financing of Terrorism) framework established under PMLA reinforces FEMA's operational scope by enhancing due diligence, reporting, and enforcement mechanisms.

Importantly, this chapter adopts a doctrinal legal analysis, reviewing statutory instruments, RBI circulars, and judicial interpretations to trace the trajectory of India's foreign exchange law. The study interrogates how the law has been calibrated to balance two competing imperatives: facilitating capital flows for economic growth and safeguarding national financial security.

The foundation for comparative legal analysis in later chapters is also laid forth in this chapter. Understanding India's domestic legal architecture is crucial for assessing how it aligns—or diverges—from foreign jurisdictions such as the United States, European Union, China, Singapore, Australia, and GCC countries. As one scholar aptly notes, "A regulatory framework in a globalized economy must not only be inwardly coherent but also outwardly interoperable."<sup>879</sup>

## 1.1 EVOLUTION OF FOREIGN EXCHANGE REGULATION IN INDIA: FROM FERA TO FEMA

India's approach to foreign exchange regulation reflects the broader trajectory of its economic philosophy—from a command-and-control model rooted in post-colonial protectionism to a liberalized regime aligned with global best practices. As aptly observed by Montek Singh Ahluwalia, "Economic reforms in India have always been accompanied by a parallel re-examination of the legal architecture governing trade and finance."<sup>880</sup> The most emblematic

<sup>873</sup> D.M. Nachane, *India's Monetary and Fiscal Policy: Post Liberalisation Perspectives* 120 (Springer, Singapore, 2018).

<sup>874</sup> *Statement of Objects and Reasons*, Foreign Exchange Management Act, 1999 (Act 42 of 1999), Reserve Bank of India, 'Master Direction – Reporting under Foreign Exchange Management Act, 1999', available at: <https://rbi.org.in/Scripts/NotificationUser.aspx?Id=10224> (last visited on Apr 12, 2025).

<sup>876</sup> Reserve Bank of India, 'Authorised Persons – Guidelines', <https://rbi.org.in/scripts/FAQView.aspx?Id=88> (last visited on Apr 12, 2025).

<sup>877</sup> Harold G. Coward, Julius J. Lipner, et al., *Hindu Ethics, Purity, Abortion, and Euthanasia* 193 (State University, New York Press, Albany, 1989).

<sup>878</sup> Financial Action Task Force, 'International Standards on Combating Money Laundering and the Financing of Terrorism & Proliferation (The FATF Recommendations)', (2012, updated 2023).

<sup>879</sup> Zoe Robinson, 'Constitutional Personhood,' 84 *Geo. Wash. L. Rev.* 605 (2016).

<sup>880</sup> Montek Singh Ahluwalia, *Backstage: The Story Behind India's High Growth Years* 93 (Rupa Publications, New Delhi, 2020).

example of this transformation is the replacement of the Foreign Exchange Regulation Act (FERA), 1973 with the Foreign Exchange Management Act (FEMA), 1999.

### 1. **FERA Era: Control and Criminalisation**

FERA was enacted at a time when India faced acute shortages in foreign exchange reserves. The law was designed to “conserve the foreign exchange resources of the country and to utilize the same in the interest of the economic development of the country.”<sup>881</sup> Based on rigid control mechanisms, FERA required almost every forex-related transaction to be approved by the Reserve Bank of India (RBI).

- Non-compliance under FERA was criminalized. Violations were treated as offences punishable with imprisonment.
- The Act severely restricted capital account transactions, including the repatriation of dividends and royalties by foreign companies operating in India.
- Judicial discourse, while not directly invalidating FERA, influenced the interpretive climate. For instance, in *Rustom Cavasjee Cooper v. Union of India*,<sup>882</sup> the Supreme Court’s expansive interpretation of Article 31 (Right to Property) laid the groundwork for later debates on economic legislation and regulatory overreach.

As scholars note, “FERA was a product of a risk-averse economic culture where the movement of capital was seen as inherently suspect and subject to strict surveillance.”<sup>883</sup>

### 2. **FEMA: Liberalization and Civil Penalties**

India’s 1991 balance of payments crisis prompted a deep rethinking of its economic model, leading to liberalization and the eventual overhaul of foreign exchange laws. In 1999, FEMA replaced FERA, signalling a shift from criminalization to compliance management.

• FEMA’s objective was to facilitate external trade and promote the orderly development of the foreign exchange market.<sup>884</sup>

• Violations are now classified as civil offenses, encouraging administrative resolution through compounding rather than criminal trials.

• The Act clearly demarcates current account transactions—which are generally permitted—and capital account transactions, which remain regulated by RBI.

• Regulatory enforcement is carried out by the Directorate of Enforcement, while the RBI and the Central Government frame policy and issue directions.

This change mirrored global trends, as pointed out in comparative economic law studies: “Developing countries moving towards capital account convertibility require adaptive legal regimes that preserve oversight without stifling growth.”<sup>885</sup>

### 3. **Key Amendments and Legal Developments**

Since its enactment, FEMA has evolved through various amendments and judicial decisions:

• The 2015 amendment expanded RBI’s control over External Commercial Borrowings (ECBs) and eased procedural compliance through enhanced compounding provisions.<sup>886</sup>

• In *Apparel Export Promotion Council v. A.K. Chopra*, the Supreme Court emphasized the civil nature of proceedings under FEMA, reinforcing the procedural rights of individuals involved in foreign exchange violations.<sup>887</sup>

• The RBI Master Directions and Foreign Exchange Manual are dynamic interpretative tools that help decode FEMA provisions and operationalize compliance frameworks for legal and financial professionals.

<sup>881</sup> Ministry of Finance, *Statement of Objects and Reasons*, Foreign Exchange Regulation Act, 1973 (Act 46 of 1973).

<sup>882</sup> *Rustom Cavasjee Cooper v. Union of India*, AIR 1970 SC 564.

<sup>883</sup> Harold G. Coward, Julius J. Lipner, et al., *Hindu Ethics, Purity, Abortion, and Euthanasia* (New York University Press, Albany, 1989).

<sup>884</sup> The Constitution of India, art. 301; Foreign Exchange Management Act, 1999 (Act 42 of 1999), *Statement of Objects and Reasons*.

<sup>885</sup> Zoe Robinson, ‘Constitutional Personhood,’ 84 Geo. Wash. L. Rev. 605 (2016).

<sup>886</sup> Ministry of Finance, ‘Foreign Exchange Management (Amendment) Rules’, (2015), available at: <https://state.gov.in/foreign-exchange-management> (last visited on Apr 13, 2025).

<sup>887</sup> *Apparel Export Promotion Council v. A.K. Chopra*, AIR 1999 SC 625.

#### 4. Integration with AML Framework

The increasing convergence of economic regulation with national and global security concerns led to FEMA's integration with India's anti-money laundering (AML) regime. Post-enactment of the Prevention of Money Laundering Act (PMLA), 2002, FEMA gained renewed relevance as a screening mechanism for illicit financial flows.

- The RBI issued detailed Know Your Customer (KYC) and AML Guidelines for Authorized Dealers, focusing on misuse of the Liberalised Remittance Scheme (LRS) and ECB routes.

- As noted by financial crime experts, *"In an era of mobile capital, domestic exchange control frameworks must be synchronized with international AML-CFT norms to ensure both economic freedom and financial integrity."*<sup>888</sup>

The transition from FERA to FEMA thus reflects India's broader economic shift—from protectionism to liberalization—while continuing to preserve regulatory oversight over cross-border transactions. This legal trajectory informs India's policy positions at global financial platforms like the IMF and FATF, and shapes its evolving stance on digital currencies, fintech, and capital account convertibility.

#### 1.2 OVERVIEW OF FEMA, 1999

The enactment of the Foreign Exchange Management Act (FEMA), 1999 marked a paradigmatic shift in India's legislative posture towards foreign exchange transactions. It replaced the restrictive and punitive Foreign Exchange Regulation Act (FERA), 1973, which had criminalized many economic activities under a statist, protectionist framework. As observed by Prof. M.P. Jain, *"FERA was a product of an era of economic isolationism, wherein the sovereign state sought to dictate the flow of capital under the guise of national interest."*<sup>889</sup>

FEMA represented a transition from "control" to "management", from prohibition to facilitation, and from criminal sanctions to civil adjudication. This transformation was necessitated by India's growing aspirations of liberalization and its entry into the global economic order following the 1991 Balance of Payments (BoP) crisis. As the RBI noted at the time, *"a modern, transparent, and rule-based foreign exchange regime was crucial for India's participation in the international financial architecture."*<sup>890</sup>

#### 1. Objectives of FEMA

The preamble to FEMA encapsulates its core goals:

- To facilitate external trade and payments, and
- To promote the orderly development and maintenance of the foreign exchange market in India.

Unlike FERA, which aimed to conserve forex, FEMA seeks to support India's economic growth by regulating capital flows without stifling them. The objective aligns with Article VIII of the IMF Charter, which encourages convertibility and non-restriction on current account transactions.

#### 2. Key Features of FEMA

FEMA's framework is progressive and adaptable to global financial realities:

- **Civil Nature of Offences:** FEMA operates through a quasi-administrative mechanism. Contraventions are treated as civil violations, with the emphasis on compounding and adjudication, not prosecution.
- **Regulatory Flexibility:** The Act allows for responsive governance, empowering both the Central Government and the RBI to issue rules, regulations, and notifications in tune with dynamic economic conditions.
- **Presumptive Permission Framework:** FEMA reverses the FERA-era presumption. Now,

<sup>888</sup> Law Commission of India, '276th Report on Legal Framework: Gambling and Sports Betting Including in Cricket in India,' 46 (July, 2018).

<sup>890</sup> Reserve Bank of India, *Annual Report 1998-99*, available at: <https://rbi.org.in> (last visited Apr. 13,

<sup>889</sup> M.P. Jain, *Indian Constitutional Law*, Vol. 1, 7th ed. (LexisNexis, 2019), p. 975.

2025).

current account transactions are presumed to be permitted, while capital account transactions require specific permission, creating an enabling legal environment.

As Justice Krishna Iyer once emphasized, *“In a modern economy, regulation must facilitate freedom while curbing abuse—not inhibit liberty under archaic pretexts.”*<sup>891</sup> FEMA embodies this principle.

### 3. **Statutory Structure and Key Provisions**

FEMA is divided into 7 chapters and 49 sections, each playing a role in demarcating regulatory responsibilities and compliance mechanisms.

- Section 3: Prohibits any dealing in foreign exchange except through *“authorized persons”* approved by the RBI. This covers both inward and outward remittances and dealings in foreign securities.
- Section 5: Permits current account transactions, subject to reasonable restrictions notified by the Government in consultation with the RBI.
- Section 6: Grants the RBI broad powers to regulate capital account transactions, which include FDI, ODI, ECB, and foreign asset acquisition by residents.
- Section 10: Empowers the RBI to appoint and regulate Authorized Persons (e.g., banks and financial entities) permitted to deal in foreign exchange.
- Section 13: Provides the enforcement architecture. Contraventions attract penalties up to three times the amount involved, with adjudication by designated authorities and appeals to the Appellate Tribunal for Foreign Exchange.

The structure is designed to be deterrent without being draconian, aiming for a balance between compliance and ease of doing business.

### 4. **Rule-Making and Delegated Legislation**

FEMA is supported by an intricate web of delegated legislation, which operationalizes its broad statutory framework through a three-tier system:

- Rules: Notified by the Central Government, such as the FEMA (Current Account Transactions) Rules, 2000 and FEMA (Capital Account Transactions) Rules, 2000.
- Regulations: Framed by the RBI on matters like inward/outward remittances, export-import, and investment vehicles.
- Master Directions & Circulars: Issued regularly to interpret, update, and clarify procedural aspects. These include sector-specific guidance and reporting obligations.<sup>892</sup>

This model ensures that the legal framework remains dynamic and adaptive, essential in a volatile global capital environment. As one commentator notes, *“In a globalized economy, static legislation is a liability; FEMA’s delegated structure is its greatest strength.”*<sup>893</sup>

### 5. **FEMA and India’s Global Economic Position**

The adoption of FEMA was not merely a domestic reform but part of India’s strategic repositioning in global finance. It supports India’s compliance with IMF Article VIII, WTO trade liberalization standards, and FATF AML/CFT guidelines.<sup>894</sup>

- FEMA underpins India’s investment-friendly ecosystem, offering legal predictability for FDI, foreign portfolio investors (FPIs), and multinational corporations.
- It complements the Prevention of Money Laundering Act (PMLA), 2002, to monitor forex-related illicit flows, especially through the Liberalised Remittance Scheme (LRS).

<sup>892</sup> RBI, ‘Master Directions’, available at: <https://rbi.org.in/scripts/NotificationUser.aspx> (last visited Apr. 13, 2025).

<sup>893</sup> S. Niranjan Reddy, *The Evolution of India’s Capital Controls*, (IJLR, Vol. 61, 2021), p. 145.

<sup>894</sup> FATF, ‘Mutual Evaluation Report – India’, 2010; available at: <https://fatf-gafi.org> (last visited Apr. 13, 2025).

<sup>891</sup> Justice V.R. Krishna Iyer, *Law and the People*, (Deep & Deep Publications, 1980), p. 147.

FEMA's structure supports India's role in international forums such as the BRICS, IMF, and G20, where capital account convertibility and digital currency regulations are actively debated.

Thus, FEMA not only governs the present but also shapes India's economic sovereignty in a globalized financial order.

### 1.3 ROLE OF THE RESERVE BANK OF INDIA (RBI) AND AUTHORIZED DEALERS (ADS)

Under the Foreign Exchange Management Act (FEMA), 1999, the Reserve Bank of India (RBI) is designated as the principal authority responsible for foreign exchange regulation and oversight in India. This authority is rooted in Section 10 of FEMA, which empowers the RBI to authorize and regulate the conduct of foreign exchange activities through designated entities. The RBI thus functions as the institutional fulcrum of India's forex regime, combining regulatory control with policy stewardship in matters involving cross-border financial flows.

Often referred to as the "custodian of India's external sector stability," the RBI's role is multidimensional, encompassing oversight of forex transactions, macroeconomic risk governance, and compliance with global standards set by institutions such as the Financial Action Task Force (FATF), International Monetary Fund (IMF), and World Trade Organization (WTO). According to the RBI's own account, its policy objectives are geared toward "ensuring that India's foreign exchange policies promote financial stability, national interest, and international alignment." This balance between sovereign autonomy and global conformity is foundational to India's approach to forex management.

To implement FEMA's provisions at the ground level, the RBI delegates operational responsibilities to specific classes of financial institutions designated as Authorized Persons. Among these, Authorized Dealers (ADs) particularly those classified as Category I and II banks—serve as critical intermediaries. They are

entrusted with facilitating transactions on behalf of individuals, corporates, and government agencies, acting as the RBI's front-line agents in enforcing compliance and ensuring procedural diligence.<sup>895</sup> This decentralized enforcement model not only widens access to forex services but also embeds regulatory oversight at transactional touchpoints.

#### 1. Statutory Mandate of the RBI under FEMA

The statutory foundation of the RBI's role under FEMA is articulated through three key provisions. Section 10 authorizes the RBI to appoint and regulate the activities of Authorized Persons, including ADs, thereby establishing its operational jurisdiction. Section 6 entrusts the RBI with responsibility over capital account transactions, empowering it to supervise foreign investments, borrowings, and overseas asset transfers.<sup>896</sup> Additionally, Section 47 provides the RBI with quasi-legislative authority to issue binding regulations and directions that govern foreign exchange transactions. Collectively, these provisions enable the RBI to act not just as an administrative regulator but as a dynamic rule-maker, capable of adapting India's forex framework to changing economic conditions and global trends.

As noted by Usha Thorat, former Deputy Governor of RBI,

*"The RBI's authority under FEMA is not merely procedural but policy-oriented, enabling it to exercise discretion in aligning external sector governance with national interest."<sup>897</sup>*

#### 2. Key Regulatory and Supervisory Functions of the RBI

A central element of the RBI's regulatory apparatus is the issuance of Master Directions, which serve as consolidated codifications of applicable rules across various forex domains.

<sup>895</sup> Shaktikanta Das, *Capital Flows and the Indian Economy*, RBI Speech at IMF Conference, 2022.  
<sup>896</sup> Reserve Bank of India, *Annual Report 2022–23*, available at: <https://rbi.org.in> (last visited Apr. 14, 2025).  
<sup>897</sup> Usha Thorat, "Role of RBI in Foreign Exchange Management," RBI Occasional Papers, Vol. 28(3), 2007.

These directions are issued for diverse sectors such as the Liberalised Remittance Scheme (LRS), External Commercial Borrowings (ECB), Foreign Direct and Overseas Investment (FDI/ODI), and the export-import of goods and services. These legal instruments are regularly updated to reflect developments in the global financial system and shifts in India's domestic policy priorities. In the words of Justice V.R. Krishna Iyer,

*"Administrative discretion must function under the rule of law, and the RBI's directions exemplify structured discretion guided by public interest."<sup>898</sup>*

In terms of foreign investment governance, the RBI plays a pivotal role in approving and monitoring capital inflows under both the automatic and government approval routes. This function is operationalized through the FIRMS portal (Foreign Investment Reporting and Management System), which facilitates digital reporting of transactions such as share allotments and remittances. Through this infrastructure, the RBI ensures that foreign investment is transparent, compliant, and traceable, thereby minimizing regulatory opacity.

Another cornerstone of the RBI's mandate is due diligence and AML/KYC enforcement. The RBI has issued detailed guidelines under its Master Direction on Know Your Customer (KYC), in consonance with the Prevention of Money Laundering Act (PMLA), 2002.<sup>9</sup> These guidelines require ADs to conduct rigorous verification of the source of funds and to report suspicious transactions. Importantly, the RBI serves as the main agency responsible for aligning India's AML framework with FATF Recommendations, particularly concerning cross-border remittance channels. This regulatory function enhances India's international standing in the fight against financial crimes.

The Liberalised Remittance Scheme (LRS), which permits resident individuals to remit up to USD

250,000 annually for eligible transactions, is another area under the RBI's purview.<sup>899</sup> While this facility empowers individuals with greater financial freedom, the RBI mandates strict compliance checks by ADs, including end-use verification and identity screening. As Governor Shaktikanta Das aptly remarked,

*"Liberalization is not without responsibility. The LRS reflects our trust in the Indian consumer and investor, balanced with necessary regulatory oversight."<sup>900</sup>*

In its macroprudential supervisory role, the RBI manages critical levers such as ECB ceilings, FDI sectoral caps, and ODI limits, all of which serve to safeguard India's external balance sheet. It also steers India's policy on rupee convertibility, especially under the current account regime, while maintaining a cautious approach toward capital account liberalization. As Kaushik Basu writes,

*"A central bank's prudential controls must balance openness with resilience, especially in emerging economies prone to volatile capital flows."<sup>901</sup>*

Lastly, the RBI also regulates Money Service Businesses (MSBs) by licensing Full-Fledged Money Changers (FFMCs) and remittance service providers. These entities are monitored for strict adherence to international AML-CFT standards and compliance with UN sanctions regimes. This area of regulation is vital in insulating India's financial system from illicit capital movements, terrorism financing, and reputational risk.

### Summary

The RBI's regulatory engagement under FEMA is multi-dimensional, encompassing policy formulation, institutional delegation, supervisory enforcement, and international harmonization. It acts not merely as a regulator but as a policy strategist, prudential supervisor, and

RBI, Master Directions Index, available at:

[https://rbi.org.in/scripts/BS\\_ViewMasDirections.aspx](https://rbi.org.in/scripts/BS_ViewMasDirections.aspx).

<sup>898</sup> Justice V.R. Krishna Iyer, *Law and Social Justice in India*, Eastern Book Co., 1985, p. 28.

<sup>900</sup> Shaktikanta Das, *Capital Flows and the Indian Economy*, RBI Speech at IMF Conference, 2022.  
<sup>901</sup> Kaushik Basu, "Capital Controls and the Balance Between Sovereignty and Integration,"

<sup>898</sup> Justice V.R. Krishna Iyer, *Law and Social Justice in India*, Eastern Book Co., 1985, p. 28. Bookings Global Papers, 2022.

compliance enforcer. Its institutional conduct is increasingly aligned with international legal standards, reflecting India's evolution as a globally responsible financial jurisdiction. As noted in the 2023 Report on Currency and Finance:

*"Monetary sovereignty today entails regulatory dexterity in managing foreign exchange flows and ensuring compliance integrity."<sup>902</sup>*

#### 1.4 FOREIGN EXCHANGE MANAGEMENT RULES FOR CURRENT AND CAPITAL ACCOUNT TRANSACTIONS

The practical implementation of the Foreign Exchange Management Act, 1999 (FEMA) hinges on two sets of rules formulated by the Central Government in consultation with the Reserve Bank of India (RBI): the *Foreign Exchange Management (Current Account Transactions) Rules, 2000* and the *Foreign Exchange Management (Permissible Capital Account Transactions) Rules, 2000*. These rules serve as the legal mechanism to operationalize the bifurcation of foreign exchange transactions into current and capital accounts, thus laying the foundation for India's exchange control regime. They outline what is permissible, restricted, or prohibited, while aligning the national framework with international best practices and obligations under the International Monetary Fund (IMF) Article VIII.

##### 1. **Current Account Transactions Rules, 2000**

Section 5 of FEMA grants a broad allowance for current account transactions, stating that "any person may sell or draw foreign exchange to or from an authorised person if such exchange is a current account transaction," subject to such reasonable restrictions as may be prescribed by the Central Government.<sup>903</sup> This permissive structure is anchored in the *Foreign Exchange Management (Current Account Transactions) Rules, 2000*, which operationalize this freedom

by defining the contours of what constitutes a current account transaction.

According to Rule 2(e), a "current account transaction" means a transaction other than a capital account transaction and includes "payments due in connection with foreign trade, other current business, services, and short-term banking and credit facilities; payments due as interest on loans and as net income from investments; remittances for living expenses of parents, spouse and children residing abroad; and expenses in connection with foreign travel, education and medical care."<sup>904</sup>

The Rules further categorize such transactions into three schedules:

- Schedule I lists *prohibited* transactions, such as remittances for lottery winnings or purchase of banned magazines.
- Schedule II contains transactions that require *prior approval from the Central Government*, like remittances for cultural tours abroad or advertisements in foreign print media other than those of the Indian missions.
- Schedule III identifies transactions that require *prior approval from the RBI*, such as gifts or donations exceeding the prescribed limit or emigration remittances beyond specified caps.<sup>905</sup>

In terms of compliance, Authorized Dealer (AD) banks serve as the first line of regulatory enforcement. They are required to examine the bona fides of each transaction and report it through the *Authorised Dealer Reporting System (ADRS)*.<sup>906</sup> RBI Master Directions complement this framework by offering detailed procedural guidance on Know Your Customer (KYC) norms and documentation.

##### 2. **Capital Account Transactions Rules, 2000**

Capital account transactions, unlike current account ones, are restrictive in nature. Section 6

<sup>902</sup> Reserve Bank of India, *Report on Currency and Finance*, 2023, p. 42.

<sup>903</sup> The Foreign Exchange Management Act, 1999 (Act 42 of 1999), s. 5.

<sup>904</sup> The Foreign Exchange Management (Current Account Transactions) Rules, 2000, r. 2(e).

<sup>905</sup> The Foreign Exchange Management (Current Account Transactions) Rules, 2000, Sch. I–III.

<sup>906</sup> Reserve Bank of India, *Authorised Dealer Reporting System (ADRS) Guidelines*, available at: [https://rbi.org.in/scripts/BS\\_ViewMasDirections.aspx](https://rbi.org.in/scripts/BS_ViewMasDirections.aspx) (last visited on Apr. 14, 2025).

of FEMA defines capital account transactions as those that “alter the assets or liabilities, including contingent liabilities, outside India of persons resident in India or assets or liabilities in India of persons resident outside India.”<sup>907</sup> Such transactions are prohibited unless expressly permitted under the *Foreign Exchange Management (Permissible Capital Account Transactions) Rules, 2000*.

Inbound capital flows permitted under these Rules include Foreign Direct Investment (FDI), External Commercial Borrowings (ECBs), and foreign venture capital investments. Outbound capital flows include Overseas Direct Investment (ODI), acquisition of immovable property abroad, and investment in foreign securities by Indian residents.<sup>908</sup>

- Rule 3 details transactions permissible for Indian residents.
- Rule 4 outlines transactions permitted for non-residents.
- Rules 5 and 6 provide the thresholds and conditions under which such transactions may proceed via the *automatic route* or with *prior RBI approval*.<sup>909</sup>

Subordinate legislation, particularly RBI’s Master Directions, ensures compliance and provides clarity. Key directives include:

- *Master Direction on External Commercial Borrowings,*
- *Master Direction on ODI/FDI Reporting,* and
- *Master Direction on Acquisition of Immovable Property.*

These regulatory instruments reflect India’s dual objectives: fostering a liberal investment environment while preserving national financial sovereignty.

### 3. Importance in the Broader Legal Framework

Together, the Current and Capital Account Transaction Rules constitute the regulatory scaffolding upon which India’s external sector policy is built. They are integral to India’s obligations under international frameworks like IMF Article VIII, the Financial Action Task Force (FATF) recommendations on anti-money laundering, and the Bank for International Settlements (BIS) supervisory principles.

The demarcation of transactions not only aids in macroeconomic stability but also protects against foreign exchange misuse for illicit or subversive purposes. As Usha Thorat aptly stated, “the RBI’s dual role in liberalising capital flows while ensuring stability reflects the careful balance that FEMA sought to institutionalize.”<sup>910</sup> Thus, these Rules are more than administrative tools—they are a reflection of India’s evolving regulatory philosophy in a globalised economy.

#### 1.5 ANTI-MONEY LAUNDERING (AML) COMPLIANCE AND REPORTING MECHANISMS IN FOREIGN EXCHANGE REGULATION

The intersection of foreign exchange regulation and anti-money laundering (AML) compliance represents a critical dimension of India’s financial governance framework. As globalization deepens and cross-border capital flows become more complex, foreign exchange systems are increasingly vulnerable to exploitation for illicit purposes, such as trade-based money laundering (TBML), terror financing, and undisclosed offshore holdings. This has led to the creation of a composite compliance structure involving legislative instruments, regulatory directions, and technological platforms that collectively aim to safeguard financial sovereignty and transparency.

<sup>907</sup> The Foreign Exchange Management Act, 1999 (Act 42 of 1999), s. 6.

<sup>908</sup> The Foreign Exchange Management (Permissible Capital Account Transactions) Rules, 2000, rr. 3–4.

<sup>909</sup> *Ibid.*, rr. 5–6.

<sup>910</sup> Usha Thorat, 'Role of RBI in Foreign Exchange Management,' 28(3) RBI Occasional Papers 1 (2007).

## 1. Legal Framework Governing AML in Forex Transactions

India's AML obligations in the context of foreign exchange are structured around a triadic legal and regulatory framework. First, the *Prevention of Money Laundering Act, 2002* (PMLA) serves as the primary criminal statute to combat the laundering of proceeds of crime. It empowers authorities to attach, seize, and confiscate property linked to scheduled offences. Importantly, foreign exchange violations linked to predicate offences such as corruption, benami transactions, or fraud fall within its purview, enabling the Enforcement Directorate (ED) to initiate investigation and prosecution under PMLA.<sup>911</sup>

Second, the Reserve Bank of India (RBI) has issued comprehensive guidelines through its *Master Direction on Know Your Customer (KYC) and Anti-Money Laundering Standards*. These norms mandate Customer Due Diligence (CDD), enhanced scrutiny for high-risk clients, and rigorous monitoring of foreign exchange transactions. Notably, the RBI guidelines also align with international obligations under the Financial Action Task Force (FATF) Recommendations, including obligations for Politically Exposed Persons (PEPs), Non-Profit Organizations (NPOs), and full traceability of wire transfers.<sup>912</sup>

Third, the *Foreign Exchange Management Act, 1999* (Act 42 of 1999) incorporates compliance requirements that, while civil in nature, bear significant implications. For instance, forex participants must provide accurate disclosures, legitimate sources of funds, and adhere to transaction routes approved by the RBI. Any deviation, especially when linked to criminal activity, may trigger parallel proceedings under the PMLA.<sup>913</sup>

## 2. Key AML Mechanisms Integrated in Forex Regulation

Among the most vital AML instruments integrated into the forex compliance architecture are Suspicious Transaction Reports (STRs) and Currency Transaction Reports (CTRs). Banks and Authorised Dealers (ADs) are obligated to file STRs when transactions appear inconsistent with a customer's profile and CTRs for any monthly cash transactions exceeding ₹10 lakhs. These reports are submitted to the Financial Intelligence Unit – India (FIU-IND), functioning under the Ministry of Finance, which acts as the central repository of AML intelligence.<sup>914</sup>

KYC compliance forms the bedrock of AML implementation in forex transactions. All remittances under the Liberalized Remittance Scheme (LRS) require valid identification, PAN-based tracking, and a declaration of the source of funds. Financial institutions must identify Ultimate Beneficial Owners (UBOs) to thwart complex layering and integration schemes often involving offshore vehicles.<sup>915</sup>

Furthermore, AML safeguards are deeply embedded into cross-border remittances and capital flows. Under LRS, for example, individuals must self-declare the purpose of remittance and ensure that funds are not diverted for unauthorized activities such as margin trading or lottery purchases. Similarly, transactions involving External Commercial Borrowings (ECBs) or Overseas Direct Investment (ODI) necessitate comprehensive disclosures on the investment structure, sources of funding, and end-use compliance. These safeguards are reinforced through supervisory oversight and statutory notifications.

India's broader AML regime also aligns with international benchmarks. According to FATF's Mutual Evaluation Report, India's legal and institutional measures demonstrate increasing convergence with global AML norms,

<sup>911</sup> *Prevention of Money Laundering Act, 2002* (Act 15 of 2003), ss. 3, 5, 8.

<sup>912</sup> Reserve Bank of India, *Master Direction – Know Your Customer (KYC) Direction*, RBI/DBR/2015-16/18 (Feb. 25, 2016).

<sup>913</sup> *Foreign Exchange Management Act, 1999* (Act 42 of 1999), ss. 10, 13, 15.

<sup>914</sup> Financial Intelligence Unit – India, 'Annual Report 2022–2023,' p. 12 (2023).

<sup>915</sup> Reserve Bank of India, *FAQs on Liberalised Remittance Scheme (LRS)*, available at: <https://www.rbi.org.in/Scripts/FAQView.aspx?Id=115> (last visited on Apr. 13, 2025).

particularly in the identification of beneficial ownership and the enforcement of targeted financial sanctions.<sup>916</sup>

### 3. *Supervisory and Technological Mechanisms*

Institutionally, the FIU-IND operates as the nodal analysis centre for financial intelligence, closely coordinating with the RBI, SEBI, and ED to trace laundering patterns linked to foreign exchange violations. In addition to inter-agency collaboration, digital infrastructures such as the Central KYC Registry (CKYCR) and the Foreign Investment Reporting and Management System (FIRMS) portal enhance compliance and reporting efficiency. Banks and ADs have also adopted real-time Transaction Monitoring Systems (TMS) using AI-driven algorithms to flag suspicious forex activity and alert regulators in a timely manner.<sup>917</sup>

### 4. *Challenges and the Evolving Compliance Environment*

Despite the strength of this legal and technological edifice, several operational challenges persist. Trade-based money laundering through over- and under-invoicing remains a formidable problem. Additionally, the creation of shell entities, discretionary offshore trusts, and round-tripping mechanisms complicate the identification of beneficial ownership. The growing use of cryptocurrency and peer-to-peer networks for cross-border transfers further circumvents regulatory visibility.

In response, regulators are adopting a risk-based compliance model, integrating sector-specific audits, and enhancing global cooperation. As the *Law Commission of India* observed in its 2018 report, "India must continually recalibrate its AML systems to ensure effective deterrence against emerging

threats posed by new financial instruments and offshore havens."<sup>918</sup>

### 1.6 FEMA AND ENFORCEMENT BY THE DIRECTORATE OF ENFORCEMENT (ED)

Although the *Foreign Exchange Management Act, 1999* (Act 42 of 1999) is primarily classified as a civil and regulatory statute aimed at facilitating foreign trade and payments, its enforcement mechanism reflects a deep institutional resolve. The Directorate of Enforcement (ED), operating under the aegis of the Department of Revenue, Ministry of Finance, holds the statutory mandate to investigate and prosecute violations of FEMA, especially those involving large-scale foreign exchange contraventions and instances where proceeds of crime are involved.

#### 1. *Role of the Enforcement Directorate under FEMA*

The ED plays a critical role in safeguarding India's financial integrity by targeting activities such as unauthorized foreign exchange remittances, use of shell companies for outward foreign investments, and trade misinvoicing intended to circumvent capital account regulations. It is empowered to conduct search and seizure operations, issue Show Cause Notices (SCNs), record sworn statements, and initiate adjudication proceedings for contraventions. As highlighted by V. Vijay Kumar, "FEMA aims at facilitating external trade and payments while maintaining orderly development and maintenance of the foreign exchange market in India."<sup>919</sup> Within this context, the ED's powers become instrumental in detecting abuse and enforcing compliance.

Moreover, the ED is authorized to initiate compounding proceedings under certain circumstances. Compounding under FEMA, as per Section 15, allows violators to voluntarily disclose infractions and settle matters without prosecution. This quasi-amnesty mechanism is

<sup>916</sup> Financial Action Task Force (FATF), 'Mutual Evaluation Report of India,' p. 30 (2018), including in *Crickets in India*, p. 44 (July, 2018).  
<sup>917</sup> Ministry of Finance, Government of India, 'Use of AI in Financial Compliance From a Regulatory Perspective,' p. 142 (LexisNexis, Gurgaon, 3rd edn., 2020).  
<sup>918</sup> Law Commission of India, '276th Report on Legal Framework: Gambling and Sports Betting

widely used for resolving non-serious violations such as delays in Foreign Direct Investment (FDI) reporting, non-filing of External Commercial Borrowing (ECB) returns, and remittances under the Liberalized Remittance Scheme (LRS) that exceed permissible limits.<sup>920</sup> This non-criminal route balances regulatory compliance with the goal of minimizing litigation.

## 2. Enforcement Mechanism and Legal Procedure

The enforcement structure under FEMA involves multiple stages. Once a suspected contravention is detected, the ED issues a Show Cause Notice to the concerned party under Section 13 of the Act. The adjudication is then carried out by an Adjudicating Authority appointed under Section 16. The decisions of the Adjudicating Authority are appealable before the Appellate Tribunal for Foreign Exchange (ATFE), and subsequently, to the jurisdictional High Court under Section 35.<sup>921</sup>

This procedural pipeline allows for checks and balances while still empowering the ED to act swiftly where necessary. In practice, however, the speed and consistency of adjudications remain a point of concern, especially when compared with the Reserve Bank of India's own mechanisms for regulatory compliance.

## 3. Interface with PMLA and Hybrid Investigations

The regulatory role of the ED becomes even more complex where FEMA violations are linked to predicate offences listed under the *Prevention of Money Laundering Act, 2002* (Act 15 of 2003). In such cases, the ED often initiates parallel proceedings under PMLA, which involve attachment of properties under Section 5, prosecution under Sections 3 and 4, and even international cooperation through Mutual Legal Assistance Treaties (MLATs). This hybrid enforcement model ensures that financial misconduct is not only met with administrative

sanctions but also criminal liability where warranted.

As noted by Badrinath Srinivasan, "the convergence of FEMA and PMLA enforcement represents a significant evolution in India's financial regulatory landscape, blurring the lines between civil regulation and criminal prosecution."<sup>922</sup>

## 4. Critiques and Legal Debates

Despite the intent of FEMA to usher in a liberalized financial regime, several legal scholars and stakeholders have raised concerns regarding the procedural fairness and due process during ED-led investigations. Critics argue that the ED's quasi-criminal powers under a civil statute create constitutional tensions, particularly in terms of personal liberty and fair hearing.<sup>923</sup>

Additionally, the absence of strict timelines for compounding decisions and the overlapping regulatory jurisdictions between the Reserve Bank of India and the ED have led to occasional uncertainty. Nevertheless, these mechanisms have served as effective deterrents, ensuring that the post-liberalization foreign exchange framework does not invite misuse or regulatory arbitrage. As *The Hindu* editorialized, "the real challenge lies in ensuring that enforcement does not override the principle of proportionality inherent in a civil law like FEMA."<sup>924</sup>

## 1.7 KEY CASE LAWS AND JUDICIAL INTERPRETATIONS

Judicial interpretation has significantly contributed to the development of foreign exchange regulation in India. The judiciary has acted as a crucial balancing force between India's aspiration for liberalized capital mobility and the imperative of regulatory control over foreign exchange to preserve economic sovereignty. In doing so, courts have interpreted

<sup>920</sup> Reserve Bank of India, 'Compounding Orders under FEMA,' <https://rbi.org.in/Scripts/Fema.aspx> (last visited on Apr 14, 2025).

<sup>921</sup> *The Foreign Exchange Management Act, 1999* (Act 42 of 1999), ss. 13, 15, 16, 35.

<sup>922</sup> Badrinath Srinivasan, 'The FEMA-PMLA Conundrum: Dual Enforcement and Its Implications,' 14 *NUJS L. Rev.* 89 (2021).

<sup>923</sup> Aishwarya Bhati, 'Due Process and FEMA: Reimagining Procedural Justice,' in S. Roy, S. Mehta (eds.), *Regulatory Overlap in India: Challenges and Way Forward*, p. 224 (Oxford University Press, New Delhi, 2020).

<sup>924</sup> Editorial, 'FEMA's Enforcement Needs Nuance, Not Aggression,' *The Hindu*, Apr. 11, 2024.

the Foreign Exchange Management Act, 1999 (FEMA) in a manner that aligns with its administrative nature, while also acknowledging the role of enforcement agencies such as the Directorate of Enforcement (ED) and the Reserve Bank of India (RBI).

The jurisprudence in this field emphasizes that FEMA is primarily a civil statute designed to facilitate foreign exchange transactions rather than to penalize them. However, the interface between FEMA and the Prevention of Money Laundering Act, 2002 (PMLA) has led to a complex legal landscape where civil contraventions can evolve into criminal investigations, particularly when cross-border money laundering is suspected. As noted in various judgments, courts have insisted on procedural fairness, adherence to natural justice, and the necessity of proportionality in executive actions under FEMA.

### **1. *ED v. Hasan Ali Khan (2011): Nexus between FEMA and PMLA***

In the case of *ED v. Hasan Ali Khan*, the Supreme Court dealt with serious allegations involving offshore accounts, hawala transactions, and large-scale foreign exchange violations. The Enforcement Directorate proceeded under the PMLA, arguing that the underlying FEMA violations were a conduit for laundering unaccounted wealth. The Court emphasized that "violations of FEMA, although civil in nature, can under certain aggravated circumstances lead to proceedings under PMLA" when linked to the generation of criminal proceeds and structured transactions across borders.<sup>925</sup>

This case marked a crucial doctrinal development in Indian legal discourse by reinforcing the concept of hybrid enforcement, where civil contraventions can trigger layered statutory action. It also underscored the importance of institutional collaboration between the ED, RBI, and the Financial

Intelligence Unit (FIU-IND) in combating economic crimes with international dimensions.

### **2. *Ketan Parekh v. Union of India (2003): Civil Character of FEMA***

The Bombay High Court in *Ketan Parekh v. Union of India* examined whether preventive detention under the Conservation of Foreign Exchange and Prevention of Smuggling Activities Act, 1974 (COFEPOSA) could be sustained when the foundational offence stemmed from FEMA violations. The Court held that "FEMA is regulatory and civil in nature, unlike the earlier FERA regime which was penal."<sup>926</sup> It observed that any preventive detention arising out of FEMA contraventions must satisfy a higher standard of necessity and justification.

This judgment is seminal in clarifying the non-criminal nature of FEMA and limiting the use of draconian measures like detention unless there is a compelling public interest. It also laid the groundwork for India's shift toward a liberal and facilitative approach to capital movement.

### **3. *Pratibha Pratisthan v. Union of India (2011): RBI's Discretion and Judicial Review***

In *Pratibha Pratisthan v. Union of India*, the Bombay High Court dealt with the RBI's refusal to permit certain foreign remittances under FEMA. Upholding the regulator's action, the Court ruled that "discretionary powers conferred upon RBI must be exercised rationally and within the bounds of proportionality."<sup>927</sup> The Court applied the doctrine of proportionality, holding that restrictions on forex transactions must serve a legitimate aim and be no more intrusive than necessary.

This case reaffirmed the constitutional boundaries within which discretionary powers must operate and emphasized that expert regulators like the RBI are not beyond judicial scrutiny, especially when individual economic rights are at stake.

<sup>925</sup> *ED v. Hasan Ali Khan*, AIR 2011 SC 1771.

<sup>926</sup> *Ketan Parekh v. Union of India*, AIR 2003 Bom 343.

<sup>927</sup> *Pratibha Pratisthan v. Union of India*, AIR 2011 Bom 117.

#### **4. J. Sekar v. Directorate of Enforcement (2018): Procedural Fairness in FEMA Adjudication**

The Madras High Court in *J. Sekar v. Directorate of Enforcement* criticized the ED's practice of issuing mechanical show cause notices without providing adequate evidence or opportunity to be heard. The Court observed that "FEMA proceedings, although civil, must adhere to the principles of natural justice and procedural fairness."<sup>928</sup> It mandated that authorities ensure timely service of notice, disclosure of material facts, and reasonable opportunity for representation before proceeding with adjudication.

This decision reinforced the quasi-judicial nature of FEMA enforcement and underlined the importance of procedural safeguards even within administrative adjudications. The ruling is frequently cited in challenges involving arbitrary executive actions under FEMA.

#### **5. Emerging Precedents and Expanded Jurisprudence**

Subsequent cases have continued to shape the understanding of FEMA enforcement. In *Union of India v. VKC Footsteps India Pvt. Ltd.*, though primarily concerning tax refunds, the Supreme Court reiterated the relevance of judicial review in matters of economic policy.<sup>929</sup> The Delhi High Court in *Ajay Sethi v. Directorate of Enforcement* highlighted delays in compounding proceedings and urged regulatory bodies to establish clear timelines.<sup>930</sup>

Furthermore, in *Directorate of Enforcement v. M/s. NDTV Ltd.*, the Delhi High Court upheld the ED's power to investigate intricate foreign investment structures under FEMA, recognizing the need for transparency and proper documentation in layered transactions.<sup>931</sup> These decisions reflect the increasing judicial sensitivity to the complexity of modern financial

flows and the importance of ensuring a fair and accountable enforcement framework.

#### **6. Jurisprudential Themes and Doctrinal Takeaways**

The collective jurisprudence in this area highlights several recurring themes. First, courts have consistently maintained the civil character of FEMA while acknowledging that serious violations may invite PMLA proceedings. Second, the principles of due process and proportionality have been invoked to ensure that regulatory discretion is not exercised arbitrarily. Third, the courts have emphasized the necessity of judicial oversight, particularly where executive or quasi-judicial actions impact fundamental rights. Lastly, the judiciary has recognized the importance of aligning domestic forex regulation with international standards such as those recommended by the Financial Action Task Force (FATF) and the International Monetary Fund (IMF), underscoring India's commitment to global financial compliance norms.

<sup>928</sup> *J. Sekar v. Directorate of Enforcement*, AIR 2018 Mad 143.

<sup>929</sup> *Union of India v. VKC Footsteps India Pvt. Ltd.*, (2020) 9 SCC 350.

<sup>930</sup> *Ajay Sethi v. Directorate of Enforcement*, WP(C) 2890/2023, Delhi High Court, decided on March 14, 2023.

<sup>931</sup> *Directorate of Enforcement v. M/s. NDTV Ltd.*, WP(C) 1041/2019, Delhi High Court, decided on July 10, 2019.