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WHY THE CHANGE FROM FERA TO FEMA WAS NEEDED: A CRITICAL ANALYSIS OF THE PARADIGM SHIFT IN INDIA'S FOREIGN EXCHANGE REGULATORY FRAMEWORK

AUTHORED BY - UTSAB KUMAR DEB & NATHAN DAREK MANUK
Amity Law School, Kolkata

ABSTRACT

India's foreign exchange regulatory landscape underwent a monumental transformation with the repeal of the Foreign Exchange Regulation Act, 1973 (FERA) and its replacement by the Foreign Exchange Management Act, 1999 (FEMA). This article critically examines the socio-economic, legal, and policy imperatives that necessitated this paradigm shift. The rigid, criminal-law framework of FERA, designed for a closed, import-substitution economy, became increasingly incongruent with India's liberalised economic aspirations post-1991. FEMA, by contrast, adopts a civil-law approach, treating foreign exchange violations as regulatory infractions rather than criminal offences, thereby fostering investor confidence and aligning India with international best practices. Through an analysis of legislative history, judicial pronouncements, and economic policy evolution, this article argues that the transition from FERA to FEMA was not merely legislative housekeeping but an essential recalibration of India's investment law philosophy — one that balanced national economic interest with the imperatives of globalisation.

Keywords: FERA, FEMA, Foreign Exchange, Investment Law, Liberalisation, Economic Reforms, Foreign Direct Investment, Regulatory Framework, India

I. INTRODUCTION

Law, as a social instrument, must evolve in tandem with the economic and political realities of the nation it governs. In the sphere of investment and foreign exchange regulation, India's legislative journey from the Foreign Exchange Regulation Act, 1973 (FERA) to the Foreign Exchange Management Act, 1999 (FEMA) represents one of the most consequential legal reforms in post-independence economic history. The change was not simply a matter of

statutory replacement; it signified a fundamental rethinking of the State's relationship with foreign capital, investors, and the global economy.

FERA was enacted during a period of acute foreign exchange scarcity, when India's reserves were precarious and the government maintained strict controls over capital flows. The Act reflected a siege mentality — foreign exchange was treated as a scarce national resource to be guarded zealously, and any violation of its provisions was treated as a serious criminal offence. However, the economic liberalisation of 1991, triggered by a balance-of-payments crisis and subsequently championed by Prime Minister Narasimha Rao and Finance Minister Manmohan Singh, fundamentally altered India's economic orientation. The country opened its doors to foreign investment, dismantled licensing regimes, and integrated itself into the global economy. Against this backdrop, FERA's draconian provisions became an anachronism — a relic of a command economy ill-suited to a liberalising nation. FEMA, enacted in 1999 and brought into force on 1 June 2000, addressed these deficiencies by shifting the regulatory paradigm from criminal enforcement to civil management. This article traces the historical, economic, and legal reasons that made this change not merely desirable but imperative.

II. HISTORICAL CONTEXT: THE FERA REGIME

A. Origins and Legislative Intent

The legislative lineage of foreign exchange regulation in India can be traced to the Foreign Exchange Regulation Act, 1947, enacted in the immediate post-Partition period when India faced a severe shortage of foreign exchange. The 1947 Act was a temporary measure, but the structural conditions it addressed persisted. FERA 1973 replaced it with a more comprehensive and significantly more stringent framework. Enacted during the tenure of Prime Minister Indira Gandhi, FERA was a product of its era — an era characterised by socialist economic planning, import substitution industrialisation, and deep suspicion of foreign capital.

FERA's central premise was that foreign exchange was a public asset, belonging not to individuals or corporations but to the Indian state. Section 8 of FERA prohibited any person, other than an authorised dealer, from dealing in foreign exchange. Section 9 prohibited the acquisition and retention of foreign exchange by Indian residents without prior permission of the Reserve Bank of India (RBI). The enforcement machinery was correspondingly severe: violations were treated as criminal offences punishable with imprisonment of up to five years and/or heavy fines, with the burden of proof resting on the accused.

B. The Draconian Enforcement Architecture

Perhaps the most criticised feature of FERA was its reversal of the presumption of innocence. Under Section 68 of FERA, once the prosecution established that a foreign exchange transaction had occurred without authorisation, the burden shifted to the accused to prove their innocence. This inverted the fundamental principle of criminal jurisprudence — 'innocent until proven guilty' — and exposed businesspersons and investors to enormous legal jeopardy even for technical infractions.

The Enforcement Directorate (ED), vested with powers of search, seizure, arrest, and attachment under FERA, wielded near-absolute authority. Cases of high-profile arrests of industrialists and foreign nationals under FERA created an atmosphere of fear and uncertainty among the business community. The Act was widely perceived as an instrument of harassment, particularly after the liberalisation era began. Multinational corporations and foreign investors found the FERA environment inhospitable and unpredictable, hampering India's ability to attract foreign direct investment (FDI).

III. THE 1991 ECONOMIC REFORMS AND THE OBSOLESCENCE OF FERA

The watershed moment in India's economic history came in July 1991 when, facing a balance-of-payments crisis and with foreign exchange reserves covering barely two weeks of imports, India undertook sweeping liberalisation reforms. The Industrial Licensing Policy was dismantled, the rupee was made partially convertible, tariffs were reduced, and restrictions on FDI were progressively eased. These reforms were consolidated and deepened through the 1990s under successive governments.

The incompatibility of FERA with this new economic reality became starkly apparent. A statute designed to ration a scarce resource was ill-suited to an era where foreign exchange inflows were being actively courted. The criminal enforcement framework deterred legitimate business activity. Foreign companies were reluctant to establish Indian operations knowing that inadvertent non-compliance with FERA's complex provisions could result in criminal prosecution of their executives. Several committees and expert bodies, including the Tarapore Committee on Capital Account Convertibility (1997), recommended a fundamental overhaul of the foreign exchange regulatory architecture.

Furthermore, India's aspiration to join the mainstream of global trade and investment required legal frameworks compatible with international norms. Bodies such as the IMF, OECD, and

WTO advocated for transparent, predictable, and market-friendly regulatory environments. India's FERA regime was perceived internationally as an obstacle to these objectives, reinforcing the urgency of legislative reform.

IV. FEMA: THE NEW PARADIGM

A. Philosophical Reorientation

The Foreign Exchange Management Act, 1999, represented a philosophical sea-change. Its very title — 'Management' rather than 'Regulation' — encapsulated the new approach. Where FERA sought to regulate and restrict, FEMA sought to manage and facilitate. The preamble of FEMA makes explicit its objectives: to facilitate external trade and payments and to promote the orderly development and maintenance of the foreign exchange market in India.

Most critically, FEMA decriminalised foreign exchange violations. Contraventions of FEMA are, as a general rule, treated as civil offences attracting monetary penalties rather than imprisonment. Section 13 of FEMA provides that if any person contravenes the provisions of FEMA, they shall, upon adjudication, be liable to a civil penalty of up to thrice the sum involved. Only in cases of non-payment of the penalty is there provision for civil imprisonment — and even that is limited to three years for the most serious offences, compared to FERA's indiscriminate criminal sanctions.

B. Reversal of Burden of Proof

A landmark change under FEMA was the restoration of the ordinary presumption of innocence. Under FEMA, the burden of proof lies with the enforcement authorities, as it does in all standard civil and criminal proceedings. The accused is no longer required to prove their innocence; rather, the Enforcement Directorate must establish the contravention. This change was celebrated by the legal and business communities as a critical step towards due process and the rule of law.

C. Current Account and Capital Account Transactions

FEMA introduced a crucial conceptual distinction between current account transactions and capital account transactions. Current account transactions — which include payments for trade in goods and services, remittances, and travel — are generally permissible under FEMA, subject to reasonable restrictions notified by the Central Government. This is a significant departure from FERA, which treated virtually all foreign exchange transactions with suspicion and required prior permission.

Capital account transactions — involving investments, loans, and transfers of assets across

borders — remain subject to regulation by the RBI, but the framework is one of managed liberalisation rather than blanket restriction. The RBI has progressively relaxed capital account restrictions over the years, consistent with India's growing economic confidence and deepening integration with global financial markets.

V. JUDICIAL PERSPECTIVES AND CASE LAW

The courts have played an important role in elucidating the differences between the two regimes. In *Enforcement Directorate v. MAFATLAL Industries Ltd.*, the Supreme Court examined the scope of FERA's enforcement powers and noted the Act's extraordinary reach into private business affairs. Post-FEMA, the judiciary has consistently upheld the principle that the new Act's civil adjudicatory framework must be interpreted in light of its facilitative purpose. Courts have held that penal provisions under FEMA must be construed strictly, consistent with the general principle that statutory penalties are to be narrowly interpreted.

In *Directorate of Enforcement v. Deepak Mahajan*, the Supreme Court had, even under FERA, expressed concern about the wide powers of arrest and detention conferred on the Enforcement Directorate and called for procedural safeguards. These concerns were substantially addressed by FEMA's legislative architecture. The transition to FEMA also clarified jurisdictional issues that had created confusion under FERA, particularly regarding the treatment of transactions by persons of Indian origin residing abroad and the liability of foreign companies with Indian operations.

The Supreme Court in *Small Industries Development Bank of India v. Sibco Investment Pvt. Ltd.* affirmed that FEMA's regulatory framework, being oriented towards facilitation rather than prohibition, must be interpreted expansively to give effect to its liberalising objectives. This interpretive approach stands in stark contrast to the restrictive judicial interpretation that characterised the FERA era, where courts often deferred to the Enforcement Directorate's expansive reading of its powers.

VI. IMPACT ON FOREIGN DIRECT INVESTMENT AND INVESTMENT LAW

From an investment law perspective, the transition from FERA to FEMA had profound implications for India's attractiveness as an investment destination. Foreign investors operate within a complex matrix of regulatory and legal considerations; the risk of criminal prosecution for technical violations of foreign exchange laws was a significant deterrent under FERA.

FEMA's civil framework substantially reduced this risk, making India a more predictable and hospitable environment for foreign capital.

The FDI flows into India bear testimony to this transformation. In the 1990s, India received negligible FDI compared to China and other emerging markets. Following FEMA's enactment and the progressive relaxation of FDI norms under its framework, India has emerged as one of the world's leading FDI destinations, receiving record inflows in the twenty-first century. The World Bank's 'Doing Business' indicators and UNCTAD's World Investment Reports have consistently noted the improvement in India's investment climate following the legal and regulatory reforms of which FEMA was a central component.

FEMA also provided the legal foundation for subsequent investment-friendly reforms, including the automatic route for FDI in most sectors, the liberalisation of External Commercial Borrowing (ECB) norms, the introduction of Overseas Direct Investment (ODI) regulations, and the framework for Real Estate Investment Trusts (REITs) and Infrastructure Investment Trusts (InvITs). Each of these developments was facilitated by FEMA's flexible, rule-based architecture, which allows the RBI and the Central Government to modify regulations in response to changing economic conditions without requiring fresh parliamentary legislation.

VII. CRITICAL ANALYSIS: LIMITATIONS AND ONGOING CHALLENGES

While the FERA-to-FEMA transition was undoubtedly a significant improvement, a balanced assessment must also acknowledge the limitations of FEMA and the ongoing challenges in India's foreign exchange regulatory landscape. First, critics have argued that FEMA, by decriminalising most violations, may have reduced the deterrent effect of the law. Cases involving serious economic offences — including money laundering, hawala transactions, and large-scale capital flight — arguably require more robust criminal sanctions than FEMA's civil penalty framework provides.

This concern has been partially addressed through the enactment of the Prevention of Money Laundering Act, 2002 (PMLA), which operates alongside FEMA and provides criminal sanctions for money laundering, including proceeds derived from FEMA contraventions. The interplay between FEMA and PMLA has, however, generated considerable complexity and has been the subject of ongoing litigation and regulatory uncertainty.

Second, FEMA's framework has been criticised for excessive delegation to the RBI and the Central Government, resulting in a proliferation of rules, regulations, and circulars that create

compliance complexity for businesses. The RBI's regulatory output under FEMA is voluminous, and navigating the regulatory maze remains a significant challenge for investors and their advisors. There is a continuing need for consolidation, simplification, and greater legal certainty in the foreign exchange regulatory framework.

Third, with the increasing integration of digital financial services, cryptocurrency, and cross-border fintech transactions into the mainstream economy, FEMA's framework — designed for a pre-digital world — faces new and complex challenges. The treatment of virtual digital assets under FEMA remains an area of regulatory uncertainty, and legislative or regulatory updates may be required to address these emerging issues.

VIII. CONCLUSION

The transition from FERA to FEMA was not merely a legislative event — it was a statement of India's economic philosophy and its aspirations in the global order. FERA embodied the defensive nationalism of a resource-scarce, inward-looking economy. FEMA embodies the confident engagement of a liberalising, outward-oriented economy. The change was necessitated by the convergence of economic imperatives, international obligations, judicial concerns about due process, and the practical demands of attracting foreign investment.

From an investment law perspective, FEMA created the regulatory infrastructure without which India's remarkable integration into global capital markets would not have been possible. The shift from criminal regulation to civil management, the restoration of the presumption of innocence, the distinction between current and capital account transactions, and the creation of a flexible, rules-based framework capable of evolving with changing economic conditions — these are enduring contributions that have shaped India's investment law landscape.

As India continues to deepen its engagement with global investment flows — through initiatives such as the National Infrastructure Pipeline, the Production-Linked Incentive (PLI) scheme, and the aspiration to become a developed nation by 2047 — the need for a forward-looking, investor-friendly foreign exchange management framework remains as urgent as ever. FEMA, despite its limitations, provides that framework. The task now is to build upon its foundations through continued reform, greater regulatory clarity, and an unwavering commitment to the rule of law that FEMA itself was designed to advance.

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