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FDI Laws in India and Protection of Foreign Investment

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ABSTRACT

With liberalised changes over the previous several years and an appealing investment climate, India's FDI situation is gradually improving. With a sustained growth in FDI, India has enticed more than 90 countries from across the world to invest in India until 2022 (up from 29 countries in 1991), putting it above the United States in the UNCTAD WIP Report's list of top investment destinations. Without the need for licenses or clearances, most investments in India might be made automatically. Foreign Investment Promotion Board approval is required for investments in industries with limits, such as single-brand retail, private banking, insurance, and stock exchange. This article assesses the history and present state of FDI inflows to India while highlighting crucial areas. Additionally, several areas that require development are emphasised so that more and more investors can invest in India through FDI, allowing India to grow and stay the most preferred location for FDI investment throughout the world.

Keywords: *Foreign Direct Investment (FDI), Indian economy, risk and benefits*

I. INTRODUCTION

The key Indian regulatory authorities in the context of Foreign Direct Investment ("FDI") are the *Foreign Investment and Promotion Board ("FIPB")*, which formulates foreign investment policy, and the *Reserve Bank of India ("RBI")*, India's central bank, with the primary responsibility of implementing and enforcing foreign exchange regulations and government policy.

Foreign investment stretches back to the days of merchants when Europeans traveled to Asia, Africa, and Latin America to deal with the natives. The assumption was that because they were already subject to their country's law, local laws could not apply to them. [3] Early academics like Grotius and Vattel supported such a stance. [4] This argument was founded on the premise that

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[3] E. de Vattel, The Law of Nations 174 (J Chitty ed, 1852), as cited TM FRANCK, FAIRNESS IN INTERNATIONAL LAW AND INSTITUTIONS (1995); H Grotius, De Jure Belli ac Pacis Tres (rev edn, 1946), reprinted in (1925) 3(2) The Classics of International Law, 385 (F. Kelsey, trans), as cited in TM FRANCK, FAIRNESS IN INTERNATIONAL LAW AND INSTITUTIONS 457 (1995)
[4] Ibid.

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these merchants took the law of their home country with them everywhere they went and were not subject to local law. Foreign investment is the transfer of tangible assets from one nation to another to generate wealth in that country under the entire or partial control of the asset owner. It has been noticed that investment treaties between capital-exporting and industrialized countries frequently include extensive treaty clauses. Such a strategy aims to ensure that a wide variety of FDI-related actions protects their (capital exporting countries') investment in another country. As a result, the courts had the vast authority to interpret these broad treaty terms, leading to many treaty disputes. As a result, it's critical to understand why a treaty provision was written in the first place and to strike a balance between national laws and treaties in terms of content.

Direct and indirect foreign investment are the two types. Investment is usually made up of several interconnected economic actions, making it a very complicated undertaking. A "person living outside India" makes a repatriation-based investment in an Indian enterprise. The residence status of the investing entity, rather than the nationality, is given considerable importance in the definition of FDI and foreign investment.

II. Historical background/background

FDI in India has a long history dating back to the founding of the British East India Company. During the British colonial period in India, the British capital arrived in India. Japanese corporations joined the Indian market after WWII and expanded their commerce with the country, although the United Kingdom remained India's most powerful investor. Following independence, policymakers began to pay attention to concerns involving foreign finance and MNC operations. Policymakers developed the FDI policy with national interests in mind, to use FDI to acquire sophisticated technology and mobilize foreign exchange resources. The FDI policy has changed over time according to economic and political regimes. MNCs were authorized to penetrate India through technical partnerships under the 1965 industrial policy.[5] As a result, the government took a more permissive stance, allowing foreign firms to participate in equity more frequently and accepting equity money in technological cooperation. However, in the 1970s, the government was forced to pursue a strict foreign policy owing to significant outflows of foreign reserves in the form of dividends, earnings, royalties, and other remittances. During this time, the government pursued a selective and very restricted foreign policy regarding foreign money, FDI types, and foreign company ownership.

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[5] Rahul Mukherji, The State, Economic Growth, and Development in India, 8(1) INDIA REVIEW 84 81-106, (2009), https://doi.org/10.1080/14736480802665238

To manage the flow of foreign capital and FDI into India, the government created the Foreign Investment Board and passed the Foreign Exchange Regulation Act. During the 1980s, the government was compelled to undertake significant reforms in foreign policy due to rising oil prices, poor exports, and a deteriorating Balance of Payments position. As a result, India's economy has only been partially liberalized. Through a steady, pragmatic, and non-discriminatory FDI flow policy, the government implements reforms in the industrial sector to boost competency, efficiency and development in the industry.[6] In response to the critical state of the Indian economy, the government of India implemented a macroeconomic stabilization and structural adjustment program with the assistance of the World Bank and the IMF. India opened its doors to FDI inflows due to these changes and implemented a more liberal foreign policy to regain foreign investor trust.

The Constitution of India empowers the Government of India to exercise its 'right to regulate matters of economic policies for the country. With limited restrictions (only under the gross violation of public interests) on such powers, the government can formulate policies pertainingabouty given time. Since 1991, India has developed several policy frameworks to regulate and manage FDI inflows and continued to experiment under the first consolidated FDI Policy.

The government, in its FDI policy, clarifies a hierarchy of laws, regulations, notifications, etc. However, even such a hierarchy has not been followed at times.[7] According to the FDI policy, the "Regulatory Framework" consists of "Acts, Regulations, Press Notes, Press Releases, Clarifications, etc." The Department of Industrial Policy and Promotion (DIPP), Ministry of Commerce & Industry, Government of India makes policy pronouncements on FDI, which the Reserve Bank notifies of India as amendments to the Foreign Exchange Management (Transfer or Issue of Security by Persons Resident Outside India) Regulations, 2000.

III. CURRENT SCENARIO, INCLUDING JUDICIAL DECISIONS

Foreign Direct Investment (FDI) has been a key non-debt financial resource for India's economic development and a crucial engine of economic growth. Foreign firms invest in India to take advantage of cheaper salaries and unique investment benefits such as tax breaks, among other things. When foreign investment is made in India, it aids the country in gaining technological know-how and creating jobs.

[6] Parvakar Sahoo, Foreign Direct Investment in South Asia: Policy, Trends, Impact and Determinants, ADB Institute Discussion Paper No. 56, ADB 9 (2006)
[7] Manohar Lal Sharma v. Union of India, (2013) 6 SCC 616

Foreign capital continues to come into India thanks to the Indian government's favorable policy framework and thriving economic climate. In recent years, the government has made several steps, including loosening FDI restrictions in areas like defense, PSU oil refineries, telecommunications, electricity exchanges, and stock exchanges, among others.

Changes in FDI policy under FEMA

Under the ministry, the Department of Economic Affairs has notified these amendments to the foreign direct investment (FDI) policy under the Foreign Exchange Management Act, 1999 (FEMA).

"In exercise of the powers conferred by clauses (aa) and (ab) of sub-section (2) of section 46 of the Foreign Exchange Management Act, 1999, the Central Government hereby makes the following rules further to amend the Foreign Exchange Management (Non-debt Instruments) Rules, 2019"

Change in FDI policy needs to be notified under FEMA for its implementation.

"Provided that an entity of a country, which shares land border with India or the beneficial owner of an investment into India who is situated in or is a citizen of any such country, shall invest only with the Government approval," it

The Directorate of Enforcement (ED) has been mandated with the task of enforcing the provisions of FEMA. The ED has been vested with wide powers including issuing summons and search and seizure powers.

The contravention of any FEMA provision, or any rule or regulation under FEMA, may incur a penalty up to three times the sum involved in the contravention where that amount is quantifiable, or up to INR 200,000 where the amount is not quantifiable. If the contravention continues, the ED can impose a further penalty which may extend to INR 5,000 for every day after the first day during which the contravention continues.

Judicial decisions

In the case of *Ehsan Khalid v. Union of India & Ors*.,[8] the Supreme Court held that when the economic policy is manifestly arbitrary, the same can be set aside by it. Similarly, the Supreme Court in *Manohar Lal Sharma v. Union of India* [9] held as under:

"14. On matters affecting policy, this Court does not interfere unless the policy is unconstitutional or contrary to the statutory provisions or arbitrary or irrational or in abuse of

[8] Ehsan Khalid v. Union of India & Ors Writ Petition (Civil) No. 429 of 2013

[9] Manohar Lal Sharma v. Union of IndiaW.P.(C) 7459/2013 & & CM APPL. 15956/2013

power. The impugned Policy that allows FDI up to 51% in multi-brand retail trading does not appear to suffer from any of these vices.”

In the case of *AP Dairy Development Corporation Federation v. B Narasimha Reddy*[10], the Supreme Court ruled that class legislation is legal as long as it is based on comprehensible differences and those differences have a reasonable relationship to the goal of the act.

Few court decisions have provided interpretative advice on the FDI policy or the rules enacted under the Foreign Exchange Management Act of 1999. (FEMA). So the judgment of Bombay High Court in *IDBI Trusteeship v Hubtown Ltd*[11] provides a welcome glimpse into the mind of the judiciary on matters related to FDI. The decision addresses whether schemes that aim to bypass FEMA limits on optionally convertible debentures are permissible (OCDs).

The court, following the approach of the Supreme Court in *Vodafone International Holdings BV v Union of India*[12] *(2012)*, looked at the transaction as a whole rather than at its constituent elements, and held that According to the facts, Vinca was used as a colorable device and was simply the formal receiver of FDI, while Amazia and Rubix were the true recipients. The structure was created to allow FMO to gain interest-bearing return of its investment from Amazia and Rubix, in violation of FDI policy and FEMA, and IDBI (through FMO) was seeking the court's help to enforce a banned transaction.

IV. CURRENT LEGAL SCENARIO OF FDI

Investment in India by non-residents requires conformity with India’s foreign exchange regulations. Most aspects of foreign currency transactions with India are governed by the Foreign Exchange Management Act, 1999 (“FEMA”) and the delegated legislations thereunder. Investments in, and acquisition of securities of, Indian companies by non-resident entities and individuals, are governed by the terms of the Foreign Exchange Management (Non-Debt Instruments) Rules, 2019 (“FEMA Non-Debt Rules”), and the provisions of the annual Consolidated Foreign Direct Investment Policy Circular (“FDI Policy”) issued by the Department for Promotion of Industry and Internal Trade (“DPIIT”) in the Ministry of Commerce and Industry, Government of India (“GoI”)[1]. The Department of Economic Affairs, Ministry of Finance, has the power to regulate equity investments in India, however, the

[10] AP Dairy Development Corporation Federation v. B Narasimha Reddy CIVIL APPEAL NO. 2188 OF 2008
[11] IDBI Trusteeship v Hubtown Ltd CIVIL APPEAL NO._10860_ of 2016
[12] Vodafone International Holdings BV v Union of India
CIVIL APPEAL NO.733 OF 2012

authority to monitor such transactions, including regulating modes of payment for such transactions still vests with the Reserve Bank of India ("RBI").

A person resident outside India, broadly, has three entry routes to make investments in India, viz., Foreign Direct Investment ("FDI"), Foreign Portfolio Investment ("FPI") and Foreign Venture Capital Investment ("FVCI").

A non-resident entity can invest in India, subject to the FDI Policy except in those sectors/activities which are prohibited. Department for Promotion of Industry and Internal Trade announced a significant change in the Consolidated Foreign Direct Investment Policy with an intention 'to curb the opportunistic takeover/acquisition of Indian Companies due to the Pandemic', changes has been made with respect to investment by India's neighbouring who shares border with India, as the note mandates that all investment made by such neighbouring countries will be through approval by Government i.e. Government Route [13].

Foreign Institutional Investor (FII) and Foreign Portfolio Investors (FPI) has been defined under Section 2 (xx) of FEMA (Transfer or Issue of Security by Persons Resident Outside India) Regulations, 2017, such investors invest in the capital of an Indian company under the Portfolio Investment Scheme which limits the individual holding of an FII/FPI below 10% of the capital of the company and the aggregate limit for FII/FPI investment to 24% of the capital of the company.

The Directorate of Enforcement (ED) has been charged with enforcing FEMA requirements. The ED has been given broad powers, including the ability to issue summonses and conduct searches and seizures.

Any violation of any FEMA statute, rule, or regulation may result in a penalty of up to three times the amount involved in the violation if that amount is measurable, or up to INR 200,000 where the amount is not quantifiable. If the violation persists, the ED may impose an additional penalty of up to INR 5,000 for each day that the violation continues after the first.

V. Critical analysis

Rule 2(s) of FEMA Non-Debt Rules defines 'foreign investment' as an investment by a person resident outside India on a repatriable basis in equity instruments of an Indian company or to the capital of an LLP. A note to the explanation to the said rule states as follows: "*a person*

[13] https://pib.gov.in/PressReleasePage.aspx?PRID=1 615711

resident outside India may hold foreign investment either_as_FDI_ *in any particular Indian company*". This note has been a subject matter of different interpretations and viewpoints and was a grey area even when Foreign Exchange Management (Transfer or Issue of Security by a Person Resident Outside India) Regulations, 2017 was in force. In our view, this note merely provides flexibility to FDI entities to invest under either of the FDI routes and does not restrict foreign portfolio investor entities to invest under only one of the routes. A similar language also appears in Schedule II(1)(a)(v) of FEMA Non-Debt Rules relating to FDIs which states as follows: "*A FDI may purchase equity instruments of an Indian company* through public offer or private placement, subject to the *individual and aggregate limits specified under this Schedule".* The use of "or" in the language does not mean that if an FPI entity has participated in private placement, it cannot participate in a public offer and vice versa. It merely provides flexibility to the FDI entities to invest in both the public offers as well as private placement.

Regulation 20(8) allows foreign portfolio investors to invest in Indian securities as a person resident outside India' in accordance with FEMA and the rules and regulations thereunder. Further, Rule 6(a) of the NDI Rules allows 'persons resident outside India' to subscribe, purchase or sell equity instruments of an Indian company under the FDI route. Thus, the conjoint reading of Rule 6(a) with Regulation 20(8) of the FDI Regulations seems to suggest that the foreign entities holding an FPI registration should be able to invest under the FDI route. Furthermore, RBI Master Direction on Reporting under FEMA stipulates that while FPI under Schedule II to FEMA Non-Debt Rules within the meaning of Rule 2(t) of FEMA Non-Debt Rules is required to be reported in Form LEC(FII) on a daily basis, any Indian company which issues equity instruments to foreign portfolio investors and which is considered as FDI within the meaning of Rule 2(r) of FEMA Non-Debt Rules, has to be reported in Form-FCGPR. The bare reading of this provision seems to suggest that an overseas entity is allowed to invest in an Indian company under both, FDI routes.

An ambiguous language and an unclear legislative intent behind the provision has been creating a commercial roadblock at times for overseas investors resulting in such investors investing through two separate overseas entities or alternatively opting for an indirect synthetic exposure in the form of offshore derivative instruments ("ODIs") such as participatory notes, swaps, equity linked notes, etc.

VI. CONCLUSION/SUGGESTIONS

Broadly speaking, Indian law recognises the freedom of parties in an international contract to choose both the governing law, the forum (arbitration/courts) and the jurisdiction for settling disputes. However, the FIPB often requires as a condition of its approval that agreements involving FDI be governed by Indian law. Litigation in India is an onerous and time-consuming process. Arbitration is therefore a popular dispute resolution option. FDI regime in India has been liberalized to a great extent and a very large number of foreign investors has benefited thorough these policies. Though there are certain important sectors like retail trade and telecommunications in which 100% FDI is not permitted but the steps are being taken by the Indian government to attract investors in these segments also. Even under the present policies, India is being viewed as an investment heaven, and it is very difficult for wise investors to ignore India.

After considering both the advantages and disadvantages of FDI, I can confidently state that, while there are some concerns regarding FDI in India, these concerns are unwarranted. It is scarcely true that it will kill India's small businesses; rather, it will benefit both customers and farmers. So, if India wants to become a developed economy, it must pursue FDI.

India requires foreign direct investment as a key component of investment for long-term economic growth and development, including job creation, expansion of current manufacturing industries, education, and research and development, among other things. The government should construct its FDI policy in such a manner that FDI inflows may be used to boost domestic production, savings, and exports through an equal distribution of FDI inflows across states, allowing them to attract FDI at their own level. At the sectoral level of the Indian economy, FDI may assist boost output, production, and exports. It is recommended that export-oriented sectors be opened up, as this would result in stronger economic growth. When you consider India's humble beginnings and where it is now, you can see how much potential it has. If the Indian government works on the areas for improvement mentioned above and continues to support and assist the encouragement of FDI into India, there is no stopping India from becoming the world's number one FDI destination, far surpassing China.

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