

AN ANALYSIS OF INDIA'S FDI REGIME FROM AN INVESTOR'S PERSPECTIVE

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ABSTRACT

*This paper examines foreign direct investment (“**FDI**”) as a significant driver for economic growth and globalization in India. Despite its growth, the legal regime governing FDI in India remains intricate, posing challenges for foreign investors seeking clarity and ease of doing business. This paper delves into the complexities of India's FDI regulations, highlighting key issues such as a complex regulatory environment, protracted approval processes, and the challenges posed by sector-specific restrictions.*

The paper adopts an investor-centric perspective to analyze these barriers and explores how they affect foreign investment decisions. To address these issues, the paper proposes certain solutions, including streamlining approval procedures, aligning sector-specific policies with global standards, and providing a clearer legal framework for dispute resolution. The objective of this paper is to consider approaches that will enhance India's appeal as an investment destination and promote sustained economic growth by recommending reforms that streamline the legal framework.

Keywords: Foreign Direct Investment, FEMA, Cross Border M&A, DPIIT, Global Economic Trends.

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I. INTRODUCTION

India has received US \$1 trillion by way of foreign direct investment (“**FDI**”) since April 2000.¹ FDI, the most common mode of foreign investment in India, is a key driver of economic growth, bringing in capital, technology and know-how. It also plays a crucial role in India’s economic development by encouraging innovation, creating jobs, improving global business connections and assisting in the development of the domestic market.

India, with its large market potential, favorable demographics, and liberalized economic policies, has become an increasingly attractive destination for FDI. In recent years, India has made significant changes to its FDI policies to create a more investor-friendly environment, adapting to global economic trends. These changes have important implications for businesses, as the government has liberalized FDI norms in sectors such as defense, civil aviation, retail, and insurance. India’s rank in ease of doing business issued by the World Bank’s Doing Business Report improved from 142 in 2014 to 63 in 2020.²

India continues to make attempts to encourage more FDI and improve its ease of doing business ranking. Most recently, the Indian Finance Minister in her budget speech on February 1, 2025 (the “**Budget Speech**”) mentioned that a High-Level Committee for Regulatory Reforms will be set up for a review of all non-financial sector regulations to further enhance ease of doing business in India.³ On February 10, 2025, an European Free Trade Association (EFTA) desk was launched pursuant to the signing of the EFTA-

India Trade and Economic Partnership Agreement.⁴ The desk has been set up to improve trade relations between India and the EFTA member states.

¹ Press Release, Press Information Bureau, India’s FDI Journey Hits \$1 Trillion, <https://www.pib.gov.in/PressReleasePage.aspx?PRID=2083683>.

² *Id.*

³ Speech of Nirmala Sitharaman, Budget 2025-2026, Minister of Finance, (Feb. 1, 2025), https://www.indiabudget.gov.in/doc/budget_speech.pdf.

⁴ Press Release, Press Information Bureau, India and EFTA Strengthen Economic Ties with the Inauguration of the India-EFTA Desk, <https://pib.gov.in/PressReleaseIframePage.aspx?PRID=2101431>.

As a general matter, Indian regulations remain complex and foreign investors expect simpler rules while considering investments in India. This paper examines India's existing legal framework in relation to FDI and discusses certain key issues from an investor's perspective.

II. BRIEF OVERVIEW OF THE LEGAL FRAMEWORK GOVERNING FDI IN INDIA

Investment by a person resident outside India (a non-resident) into equity instruments of: (a) an unlisted Indian entity; or (b) listed Indian company amounting to 10% or more of the listed company's equity share capital, constitutes FDI under Indian regulations.⁵ An investment by a non-resident into equity instruments of a listed Indian company where the investment is less than 10% of the listed company's equity share capital is considered as 'foreign portfolio investment'.⁶

FDI in India is primarily regulated by the Foreign Exchange Management Act, 1999 ("**FEMA**"), along with rules and regulations thereunder issued by the Reserve Bank of India ("**RBI**") or the Ministry of Finance, Government of India. Key regulations that govern FDI include the Foreign Exchange Management (Non-debt Instruments) Rules, 2019⁵ and the Foreign Exchange Management (Mode of Payment and Reporting of Non-debt Instruments) Regulations, 2019, each, as amended (together, the "**NDI Rules**"). Additionally, the Department for Promotion of Industry and Internal Trade, Ministry of Commerce and Industry (the "**DPIIT**") issues the Consolidated FDI Policy, including the press notes and circulars thereunder (the "**FDI Policy**") which sets out the framework for foreign investment in India FDI Routes.

There are two entry routes through which the investments can be made by non-residents:

- **Automatic route:** Automatic route is the entry route through which

⁵ Foreign Exchange Management (Non-debt Instruments) Rules, 2019, ⁵Foreign Exchange Management (Non-debt Instruments) Rules, 2019, Gazette of India, pt. II sec.3(i), Rule 2 (Oct. 17, 2019).

⁶ *Id.*

investment by a non-resident does not require the prior approval of the relevant branch of the Government of India.

- **Government route:** Government route is the entry route through which investment by a non-resident requires prior approval of the relevant branch of the Government of India.⁷ Investment through the approval route is required for FDI in certain sectors (*discussed in C.(ii) below*) or by entities incorporated in a country sharing a land border with India (a “**Bordering Country**”) or whose beneficial owners are situated in or are citizens of a Bordering Country (*discussed in C.(iii) below*).

(i) Sector specific caps on FDI

The FDI Policy imposes certain conditions for FDI in certain sectors. For such sectors, the conditions are typically in relation to: (i) the percentage of FDI permitted, (ii) entry route (automatic route or government approval route), and (iii) financial or operational conditions.⁸

III. KEY LEGAL ISSUES FOR INVESTORS

This section discusses certain key legal issues that non-resident investors face while investing in India.

(i) Application Process; Delays in Approvals

The DPIIT, along with the relevant administrative ministry/department, are responsible for processing applications seeking governmental approval for FDI. Such applications are required to be filed on the National Single Window System Portal.⁹

With the intent of simplifying the approval process for FDI, the DPIIT issued

⁷ *Id.*

⁸ Department for Promotion of Industry and Internal Trade, Consolidated FDI Policy (2020), https://www.meity.gov.in/writereaddata/files/FDI-PolicyCircular-2020-29October2020_0.pdf.

⁹ Department for Promotion of Industry & Internal Trade, Standard Operating Procedure (SOP) for Processing Foreign Direct Investment (FDI) Proposals (2023), <https://fifp.gov.in/Forms/SOP.pdf>.

a new standard operating procedure for processing FDI proposals dated August 17, 2023 (“**SOP**”) setting out the procedure, steps, timelines and documents to be uploaded to the online portal.¹⁰ The SOP is aimed at rendering the process of filing FDI applications completely paperless.

With respect to the approximate timeline for the approval process, the SOP prescribes an indicative timeline of 12 weeks from the date of submission of the application, excluding time taken by applicants in removing deficiencies in the proposals and supplying additional information, as required.¹¹ However, the effective time taken for disposal of the application is generally longer. The timelines for the approval depend upon factors such as the sector for which the application is made (e.g, if national security considerations are relevant) and other nuances of the application (for example, whether approval is required under Press Note No. 3 (2020 Series) dated April 17, 2020, (the “**Press Note 3**”). This is primarily attributable to the level of scrutiny involved and the interplay between several departments and ministries in the decision-making process.

Uncertainty as to the timelines involved in obtaining FDI approval is a deterrent for foreign investors and often makes transactions unviable. In particular, applications which involve requesting approvals in relation to Press Note 3 are susceptible to much greater certainty.

Recommendations

- 1. Time-bound decision making in respect of FDI proposals is critical. The timelines set out in the SOP need to be strictly adhered by the DPIIT and/or the relevant Government department reviewing the FDI proposal. It may be helpful to consider a “deemed approval” provision if an application remains pending beyond the prescribed period – this would incentivize the relevant departments to say “yes” or “no” rather than to keep applications pending without a decision.*
- 2. Data should be published regularly disclosing: (a) time-period involved in obtaining FDI approval; (b) description of any policy issues considered by the Government; and (c) reasons*

¹⁰ *Id.*

¹¹ *Id.*

for rejection of any FDI proposal. This would lead to greater transparency and would be helpful for investors for multiple reasons, including to serve as a reference for future applications.

(ii) Pricing Regulations

Under the Indian exchange control regulations, pricing of securities in case of a fresh issue by an Indian entity to a non-resident, or the sale of an Indian entity's securities by a resident to a non-resident, the price paid by the non-resident must be at least

1. in case of listed securities, the price at which preferential allotments may be made under the relevant regulations framed by the SEBI (which is linked to the trading price of the securities); and
2. in case of unlisted securities, the "fair value" of such securities calculated in accordance with any internationally accepted pricing method on an arm's length basis.¹²

In the event of sale of securities of an Indian entity by a non-resident to a resident, the consideration paid by the resident must not exceed the minimum price specified above.¹³ Pricing restrictions do not apply in case of transfer of shares of an Indian entity between two non-residents.¹⁴

In the case of convertible instruments, the price or conversion formula should be determined upfront at the time of issue of the relevant securities.¹⁵ The conversion price may not, in any event, be lower than the price determined at the time of issue of such securities in the manner specified above.¹⁶

Recommendations

The Government should consider whether the pricing restrictions (and related reporting

¹² Foreign Exchange Management (Non-debt Instruments) Rules, 2019, Gazette of India, pt. II sec.3(i), Rule 21 (Oct. 17, 2019).

¹³ *Id.*

¹⁴ *Id.*

¹⁵ *Id.*

¹⁶ *Id.*

requirements) which tend to work to the disadvantage of foreign investors continue to serve any useful purpose and should be progressively diluted with the aim to remove them over a defined time-period. Regulation of the price at which shares are transacted should be left to other more appropriate laws and regulations, including SEBI regulations (for listed companies) and tax and transfer pricing regulations.

(iii) Sectoral Restrictions and Ownership Caps

The FDI Policy sets out sector-specific investment limits based on the sensitivity of each industry, applying to both sectors under the automatic route and those requiring government approval.¹⁷ While foreign investment is permitted up to 100% in several sectors under the automatic route, certain performance conditions, such as minimum capitalization requirements and exit norms may apply.

For example, only 51% FDI is permitted in multi brand retail trading under the government approval route with additional conditions, which include that the minimum FDI amount to be brought in by the non-resident is US\$ 100 million.¹⁸ Similarly, while 100% FDI is permitted in single brand product retail trading, in cases of more than 51% foreign investment in the sector, certain domestic sourcing requirements are applicable, with at least 30% of the value of goods purchased to be acquired in India.¹⁹

FDI is completely prohibited in certain sectors such as, lotteries, gambling and betting.²⁰ For industries that are not explicitly restricted or regulated, the policy generally allows up to 100% foreign investment through the automatic route.

The Government has recently announced further liberalization of certain sector specific caps as set forth below:

- In February 2024, FDI in the space sector was liberalized, with: (a) 100%

¹⁷ Department for Promotion of Industry and Internal Trade, Consolidated FDI Policy (2020), https://www.meity.gov.in/writereaddata/files/FDI-PolicyCircular-2020-29October2020_0.pdf.

¹⁸ *Id.*

¹⁹ *Id.*

²⁰ *Id.*

FDI permitted under the automatic route for manufacturing of components and systems for satellites, ground segment and user segment; (b) 74% FDI permitted under the automatic route for satellites manufacturing and operation, satellite data products and ground segment and user segment; and (c) 49% FDI permitted under the automatic route for launch vehicles and creation of spaceports for launching and receiving spacecrafts.²¹

- India's Finance Minister announced as part of the Budget Speech that the FDI limit for the insurance sector will be increased to 100% and that this enhanced limit of 100% will be available to companies which invest the "entire premium" in India.²² Changes to the existing legal framework to make this proposal effective are awaited.

Recommendations

The Government has been taking the initiative to liberalise its FDI policies with respect to ownership caps; however, sectoral restrictions often become a roadblock for investors. Such conditions need to be carefully reviewed and calibrated on a periodic basis.

(iv) Press Note 3 of 2020

In 2020, the Government of India introduced measures to restrict foreign investments from Bordering Countries through the introduction of Press Note 3 and amendments to the NDI Rules.²³ Pursuant to these measures, prior approval from the Ministry of Home Affairs ("MHA") is required for investments where the entity is incorporated in a Bordering Country or whose the beneficial owner is located in a Bordering Country or is a citizen of such a country.²⁴ The MHA oversees approvals related to both direct foreign investments and any transfer of

²¹ Press Note No.1 (2024 Series), Department for Promotion of Industry & Internal Trade (DPIIT), FDI Policy Section, Mar. 4, 2024 (India).

²² Budget 2025-2026, *supra* note 3.

²³ Press Note No.3 (2020 Series), Department for Promotion of Industry & Internal Trade (DPIIT), FDI Policy Section, Apr. 17, 2020 (India).

²⁴ *Id.*

ownership resulting in beneficial ownership from a Bordering Country.

None of Press Note 3, the NDI Rules or the FDI Policy defines a “beneficial owner.” In practice, definitions from the Companies Act, 2013 (the “**Companies Act**”) and the Prevention of Money Laundering Act, 2002 (“**PMLA**”) have been relied upon. Under the Companies Act, a beneficial owner is an individual holding at least 10% of shares, voting rights, or control in a company.²⁵ Similarly, the PMLA and Know Your Customer (“**KYC**”) norms defined a beneficial owner as someone with at least 10% ownership or control (this was previously 25% and was revised in March 2023).²⁶ The DPIIT has indicated that as Press Note 3 does not specify any threshold percentage, even a miniscule percentage of ownership or control by a beneficial owner from a Bordering Country is relevant for purposes of Press Note 3.

In addition to the ambiguity regarding a threshold percentage to address *de minimis* situations in which FDI approval should not be required, there is no guidance with respect to the determination of a beneficial owner in fund structures, which will typically have multiple investors. Authorized Dealer Banks (“**AD Banks**”), which facilitate foreign investments, have been inconsistent in their application of these thresholds, leading to further uncertainty in the market.

Existing investors from the Bordering Countries may also have share ownership in Indian investee companies and may seek to participate in transactions involving such companies, including participating in bonus or rights issues of such companies to maintain their existing shareholding. However, pursuant to Press Note 3, these would trigger prior government approval and any additional investments made by such investors in their existing wholly owned subsidiaries in India would also trigger such approval requirement.

Recommendations

1. *The Government should consider providing a clear definition of “beneficial ownership” specifically for Press Note 3 and the NDI Rules.*

²⁵ *Companies Act*, No. 18 of 2013, (India).

²⁶ *Prevention of Money-laundering Act*, No. 15 of 2003, (India).

2. *Any investment of less than 10% in a investing entity from a person or entity in a Bordering Country should not be considered relevant from a Press Note 3 perspective.*
3. *Limited exceptions should be considered for rights or bonus issuances to persons or entities from Bordering Countries who had invested prior to the issuance of Press Note 3 (subject to review in relation to the first such rights or bonus issuance).*
4. *A nuanced approach is warranted for FDI from Bordering Countries (particularly, China) to achieve a balance between the Press Note 3 measures and benefits for the Indian industry – for instance, sectors with low sensitivity from a national security perspective could be excluded from the scope of Press Note 3.*

(v) Deferred Consideration and Indemnity Holdbacks

In cross border M&A transactions, negotiating indemnity obligations is a critical aspect, with unsatisfactory seller indemnities often causing deals to fall through. The FEMA imposes restrictions on deferred consideration and indemnity holdbacks in transactions where foreign buyers are involved. Deferred consideration is limited to 25% of the total purchase price for up to 18 months from the date of the transfer agreement.²⁷ Similarly, indemnity payments of not more than 25% of the total purchase price can be paid by the resident seller for a period not exceeding 18 months from the date of the payment of the full consideration, if the total consideration has been paid by the buyer to the seller.²⁸ Any deferred amount / indemnity payment exceeding this limit or deferrals / indemnity payout beyond 18 months require prior approval of the RBI.

In January 2025, clarifications have been issued stating that the restrictions with respect to deferred consideration and indemnity holdbacks are also applicable to investments made in an Indian entity by another Indian entity which is majority owned or controlled by non-residents (“**FOCCs**”).²⁹ Previously, there was lack of clarity on whether deferred consideration and indemnity holdbacks were

²⁷ Foreign Exchange Management (Non-debt Instruments) Rules, 2019, Gazette of India, pt. II sec.3(i), Rule 9, (Oct. 17, 2019).

²⁸ *Id.*

²⁹ Reserve Bank of India, Master Direction – Foreign Investment in India (Updated Jan. 20, 2025), https://rbi.org.in/scripts/BS_ViewMasDirections.aspx?id=11200.

permissible with regard to investments by FOCCs.

In practice, the RBI rarely approves indemnities exceeding the limits discussed above. The limit of 25% of the purchase price and an 18-month holdback period significantly reduces the protection for acquirers, leaving them exposed if issues surface after the 18-month period has expired.

Recommendations

The limitations on deferred consideration and indemnity holdbacks need to be reviewed. Greater flexibility needs to be provided for parties to mutually agree appropriate deferred consideration and indemnity holdback provisions.

(vi) Cross-Border Escrow Arrangements

An escrow arrangement is typically set up between parties in cases where there are conditions precedent which require time for completion, or a milestone-based payment is contemplated or a regulatory approval is pending. The FEMA mandates that an escrow arrangement involving a non-resident party must not exceed 18 months from the date the transfer agreement is signed and any escrow should be a non-interest-bearing account.³⁰

18 months is a short time frame particularly when the escrow has been set up for transactions requiring regulatory approval or if any disputes arise between the buyer and seller with respect to the successful completion of a condition precedent. Further, an escrow arrangement which is interest-free presents a disadvantage for foreign investors, particularly in transactions involving large sums of money.

Recommendations

Similar to the restrictions on deferred consideration and indemnity holdbacks, the limitations on escrow arrangements with non-resident parties should be reviewed. Greater flexibility should be provided to the parties to agree on appropriate escrow arrangements that are relevant to their

³⁰Foreign Exchange Management (Non-debt Instruments) Rules, 2019, Gazette of India, pt. II sec.3(i), Rule 9, (Oct. 17, 2019).

transaction.

(vii) Dispute Resolution and Investor Protection

India is a party to Bilateral Investment Treaties (“**BITs**”) which offer essential protections for foreign investors, ensuring that their investments are safeguarded under international law.³¹ BITs are reciprocal agreements between two countries aimed at promoting and protecting investments, providing safeguards against unfair treatment, and establishing mechanisms for resolving disputes between investors and host states.

BITs are intended protections to foreign investors, such as ensuring fair and equitable treatment, protection from discriminatory actions, and shielding investments from arbitrary state actions. India has terminated several BITs since 2016,³² and has sought to negotiate new international investment agreements based on the Model Text for the Indian Bilateral Investment Treaty (“**Model BIT**”).³³ The Model BIT was adopted as a response to an increasing number of Investor-State Dispute Settlement claims involving India.

One provision in the Model BIT which has not been considered investor friendly is the requirement to exhaust local remedies for a period of at least five years before taking recourse to the dispute resolution mechanism under the BIT. In February 2024, India and UAE signed a new BIT (“**India-UAE BIT**”) which became effective on August 31, 2024.³⁴ The time-period for pursuing local remedies in the India-UAE BIT has been reduced to three years in the India-

³¹ United Nations Conference on Trade and Development (UNCTAD), International Investment Agreements Navigator, INVESTMENT POLICY HUB, <https://investmentpolicy.unctad.org/international-investment-agreements/countries/96/india>.

³² Department of Economic Affairs, Bilateral Investment Treaties (BITs)/Agreements, <https://dea.gov.in/bipa>.

³³ Department of Economic Affairs, Model Text for the Indian Bilateral Investment Treaty (2015), https://dea.gov.in/sites/default/files/ModelBIT_Annex_0.pdf.

³⁴ Press Release, Press Information Bureau, Bilateral Investment Treaty between India and the United Arab Emirates, giving continuity of investment protection to investors of both the countries, comes into effect, (Oct. 7, 2024), [https://pib.gov.in/PressReleasePage.aspx?PRID=2062692#:~:text=The%20Bilateral%20Investment%20Treaty%20\(BIT,from%2031st%20August%2C%202024](https://pib.gov.in/PressReleasePage.aspx?PRID=2062692#:~:text=The%20Bilateral%20Investment%20Treaty%20(BIT,from%2031st%20August%2C%202024).

UAEBIT and only requires the foreign investor to 'pursue' such remedies (rather than exhausting local remedies).

Recommendations

India's evolving approach to creating favorable investment conditions through amended BITs are helpful steps. The Budget Speech has also mentioned that the Model BIT will be revamped to make it more investor friendly.³⁵ This should be undertaken in a time bound manner.

IV. CONCLUSION

India's evolving business environment presents ample opportunities for foreign investors. However, as highlighted in this paper, there are several aspects of India's FDI framework that require careful review and revision to make India a more attractive FDI destination.

Hence, the recurring instances of front-running in the market, complemented by the obscure nature of the crime, necessitate the requirement of a robust, efficient, and stringent system, both external and internal to the institution. The framework and whistleblower mechanism mandated by SEBI can be a step forward in the right direction, provided that the regulator monitors the efficiency of the internal mechanism and penalizes defaults to deter any violations on the part of the institution.

³⁵ Budget 2025-2026, *supra* note 3.