
LOOPHOLES IN THE FDI APPROVAL MECHANISM IN INDIA: A CRITICAL STUDY UNDER FEMA AND SEBI JURISPRUDENCE

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ABSTRACT

Foreign Direct Investment (FDI) occupies a central position in India's economic architecture, serving as a conduit for capital inflows, technological advancement, and integration into global financial markets. The regulatory framework governing FDI is principally anchored in the Foreign Exchange Management Act, 1999 (FEMA), augmented by capital market regulations administered by the Securities and Exchange Board of India (SEBI) and executive policies issued by the Department for Promotion of Industry and Internal Trade (DPIIT). Notwithstanding considerable liberalisation over the past three decades, the FDI approval mechanism continues to be beset by structural and procedural inadequacies that adversely affect regulatory transparency, jurisdictional coherence, and enforcement efficacy. This paper critically examines these loopholes arising from regulatory overlap, administrative discretion in the Government Route, ambiguity in sectoral restrictions, and deficiencies in post-approval monitoring and interrogates SEBI's adjudicatory role in foreign investment-related violations. It argues that the FDI framework, despite its apparent comprehensiveness, suffers from fragmented implementation that generates interpretational uncertainty and systemic enforcement gaps, and aims to contribute to a rigorous understanding of India's investment law regime.

Keywords: Foreign Direct Investment, Regulatory Overlap, Enforcement mechanism.

LITERATURE REVIEW

Existing scholarship on FDI in India has predominantly traced the regulatory evolution under FEMA and examined SEBI's institutional role in capital market governance. A substantial body of literature addresses the transition from FERA to FEMA, emphasising legislative intent and successive rounds of liberalisation. While such works have contributed meaningfully to understanding the formal contours of the investment regime, they operate largely within the confines of doctrinal exposition, leaving structural deficiencies, administrative discretion, and regulatory fragmentation underexplored.

Scholarly engagement with SEBI's regulatory functions particularly in relation to disclosure norms, the takeover regime, and insider trading has been extensive, yet the specific interface between SEBI's mandate and FEMA's investment conditions remains insufficiently examined. Issues such as the discretionary exercise of Government Route powers, jurisdictional ambiguities arising from concurrent oversight, and post-approval monitoring inadequacies have largely escaped sustained doctrinal analysis. This paper addresses those lacunae by undertaking a focused critical analysis of the structural and procedural deficiencies embedded within India's FDI approval mechanism, with particular attention to the legal interface between FEMA provisions and SEBI jurisprudence.

RESEARCH QUESTIONS

This study is guided by the following research questions:

1. Whether the FDI approval mechanism under FEMA ensures adequate clarity and transparency in the regulation of foreign investment in India?
2. What structural and procedural loopholes subsist within the Government Route of FDI approvals, and to what extent do they undermine regulatory certainty?
3. How has SEBI jurisprudence engaged with the regulatory challenges arising from foreign investment, and whether its adjudicatory approach has been doctrinally consistent?
4. To what extent do overlapping jurisdictions among the RBI, SEBI, and administrative ministries generate interpretational inconsistencies and enforcement gaps?

5. Whether the existing post-investment compliance and monitoring framework is adequate to address the complexities of modern cross-border investment structures?

RESEARCH METHODOLOGY

This study adopts a doctrinal and analytical methodology, confined exclusively to Indian investment law. Primary sources relied upon include the Foreign Exchange Management Act, 1999; the Securities and Exchange Board of India Act, 1992; the Securities Contracts (Regulation) Act, 1956; the Depositories Act, 1996; the Companies Act, 2013; the Foreign Exchange Management (Non-Debt Instruments) Rules, 2019; the Consolidated FDI Policy; and relevant SEBI regulations. Secondary sources include SEBI annual reports, ICSI study materials, DPIIT policy documents, and academic commentaries. The method involves close reading of statutory provisions, regulatory guidelines, and judicial decisions to identify interpretational ambiguities and structural gaps. The scope is limited to Indian investment law; no comparative analysis with foreign jurisdictions has been undertaken.

INTRODUCTION

Foreign Direct Investment (FDI) has assumed an increasingly foundational role in India's economic policy, particularly in the post-liberalisation era. As a principal mechanism for capital inflow, technology transfer, and integration into global production networks, FDI is regulated through a complex multi-layered framework anchored in the Foreign Exchange Management Act, 1999 (FEMA)¹ and supplemented by sector-specific executive policies and capital market regulations administered by the Securities and Exchange Board of India (SEBI)². The shift from the prohibitive regime under FERA to the facilitative architecture of FEMA represents a decisive normative transition reorienting the State's approach to foreign exchange from control to calibrated management.

The FDI regime operates through a dual-route mechanism. Under the Automatic Route, foreign investments may proceed without prior governmental sanction, subject to sectoral caps and prescribed conditions. Under the Government Route, prior approval is mandatory in specified sensitive sectors as enumerated in the Consolidated FDI Policy³. While this binary structure

¹ Foreign Exchange Management Act, 1999.

² Securities and Exchange Board of India Act, 1992.

³ Consolidated FDI Policy, Government of India (latest edition).

purports to balance regulatory oversight with investor facilitation, its practical operation generates procedural opacity, administrative discretion, and interpretational unpredictability particularly under the Government Route.

The regulatory landscape is further complicated by the concurrent involvement of the Reserve Bank of India (RBI), SEBI, and administrative ministries, frequently generating jurisdictional overlaps and fragmented enforcement. Judicial bodies, including the Securities Appellate Tribunal (SAT), have intervened to resolve interpretational disputes, yet SEBI jurisprudence has not consistently furnished doctrinal clarity, particularly in matters concerning beneficial ownership, disclosure obligations, and indirect foreign investment. The Supreme Court in *Sahara India Real Estate Corp Ltd v SEBI*⁴ affirmed the expansive statutory powers of SEBI while foregrounding the institutional challenges in ensuring uniform enforcement. The proliferation of sophisticated investment structures layered subsidiaries, participatory instruments, and offshore entities has further exposed regulatory vulnerabilities. This paper critically examines these structural and procedural loopholes to assess their implications for regulatory coherence and investor confidence.

REGULATORY FRAMEWORK FOR FDI IN INDIA

FEMA and the RBI Regulatory Architecture

The legal foundation of FDI in India is constituted by FEMA, 1999⁵, which supplanted FERA's prohibitive orientation to establish a facilitative framework premised upon current account convertibility and regulated capital account transactions. Within this framework, the RBI is vested with authority to regulate foreign exchange transactions and capital inflows through FDI⁶, operationalised principally through the Foreign Exchange Management (Non-Debt Instruments) Rules, 2019, which prescribe sectoral caps, entry routes, pricing guidelines, and reporting requirements.

Notwithstanding its facilitative design, the framework exhibits identifiable structural ambiguities. The extensive reliance on delegated legislation rules, notifications, and circulars frequently amended without legislative deliberation generates interpretational complexity and

⁴ *Sahara India Real Estate Corp Ltd v SEBI*, (2012) 10 SCC 603.

⁵ Foreign Exchange Management Act, 1999.

⁶ Foreign Exchange Management (Non-Debt Instruments) Rules, 2019. ⁷ Securities and Exchange Board of India Act, 1992.

regulatory volatility. A structurally significant concern lies in the post facto reporting mechanism embedded within FEMA. Investments under the Automatic Route, though not requiring prior approval, are subject to reporting through Forms FC-GPR and FC-TRS within stipulated timelines. While this ex post model reduces transactional friction, it correspondingly curtails preventive regulatory scrutiny, leaving complex investment structures insufficiently examined until after their consequences have materialised.

SEBI's Role in Capital Market Regulation

While FEMA and the RBI govern capital flows, SEBI exercises a distinct and equally consequential regulatory mandate over investments in listed entities under the SEBI Act, 1992⁷. SEBI's jurisdiction encompasses disclosure requirements, insider trading prohibition, takeover regulation, and market integrity all directly relevant to foreign investors in Indian securities markets. The SEBI (Listing Obligations and Disclosure Requirements) Regulations, 2015 and the SEBI (Substantial Acquisition of Shares and Takeovers) Regulations, 2011 impose substantial compliance obligations concerning ownership transparency and beneficial control.

However, the interface between FEMA and SEBI regulations frequently produces jurisdictional overlap and interpretational ambiguity. In *SEBI v Rakhi Trading Pvt Ltd*⁷, the Supreme Court affirmed SEBI's broad authority to address market manipulation, yet the precise boundaries of SEBI's jurisdiction relative to FEMA provisions particularly in indirect acquisitions and convertible instruments remain inadequately delineated. SEBI's enforcement framework is, moreover, predominantly reactive, being activated in response to detected violations rather than as preventive oversight, a structural weakness that diminishes overall regulatory coherence.

FDI APPROVAL MECHANISM

The Automatic Route

The Automatic Route permits foreign investors to proceed without prior governmental sanction, provided the investment conforms to applicable sectoral caps and conditions under FEMA⁹. Principal compliance obligations are discharged through post-investment filings Form

⁷ *SEBI v Rakhi Trading Pvt Ltd*, (2018) 13 SCC 753.

⁹ Foreign Exchange Management Act, 1999.

FC-GPR upon issuance of securities and Form FC-TRS upon transfer of shareholding within stipulated timelines⁸. Despite its facilitative design, the route is not insulated from structural regulatory concerns. The ex post facto compliance architecture creates a window of regulatory opacity during which violations mispricing, non-disclosure of beneficial ownership, or investment in a conditionally restricted sector may remain undetected. Ambiguities in sectoral cap delineation generate interpretational difficulties, and the absence of real-time verification materially limits the capacity of authorities to identify noncompliance at a practicable remedial stage.

The Government Route and the Approval Process

The Government Route mandates prior governmental approval for investments in sensitive sectors, as specified in the Consolidated FDI Policy⁹, processed through the Foreign Investment Facilitation Portal (FIFP)¹⁰. While designed to ensure oversight in areas of national importance, it simultaneously constitutes the most significant locus of procedural inefficiency and legal indeterminacy within the FDI framework. The absence of codified statutory timelines and uniform decision-making criteria leaves approvals subject to unarticulated policy considerations, antithetical to the principle of legal certainty. Institutional fragmentation arising from the involvement of multiple ministries produces inconsistent outcomes across materially similar proposals. The insufficiency of reasoning accompanying approval or rejection orders, unlike SEBI's published quasi-judicial orders subject to appellate review, constrains accountability and impedes jurisprudential development. The progressive use of the Route as an instrument of policy-driven regulation without clearly defined legal standards governing the invocation of national security considerations creates substantial scope for arbitrary application, constituting a structural loophole that deters legitimate investment.

LOOPHOLES IN THE FDI APPROVAL PROCESS

Regulatory Ambiguities and Administrative Discretion

Among the most consequential loopholes is the structural ambiguity embedded within FEMA and the Consolidated FDI Policy¹¹. Broad and indeterminate language in sectoral provisions

⁸ Foreign Exchange Management (Non-Debt Instruments) Rules, 2019.

⁹ Consolidated FDI Policy, Government of India (latest edition).

¹⁰ DPIIT, Standard Operating Procedure for Processing FDI Proposals (FIFP).

¹¹ Consolidated FDI Policy, Government of India (latest edition).

confers wide interpretative latitude upon multiple regulatory authorities whose approaches may diverge significantly. Foundational concepts such as "control," "ownership," and "beneficial interest" lack uniform statutory definitions, compounding inconsistency. In the absence of codified and publicly accessible approval criteria, administrative decisions under the Government Route may be shaped by unarticulated policy considerations, fundamentally at odds with the principle of legal certainty indispensable to effective investment regulation. Frequent amendments to FDI norms through executive notifications without adequate transitional provisions further subject investors to continuous normative flux, imposing disproportionate compliance burdens upon those with long-term investment horizons.

Jurisdictional Overlaps and Fragmented Regulation

Concurrent jurisdiction among the RBI, SEBI, and administrative ministries generates unavoidable duplication of compliance obligations and inconsistent regulatory interpretation. A transaction in a listed company simultaneously attracts FEMA provisions on foreign ownership limits and SEBI regulations on disclosure and takeover thresholds. In *SEBI v Rakhi Trading Pvt Ltd*¹², the Supreme Court recognised SEBI's expansive market conduct authority, yet the normative tensions at the FEMA-SEBI intersection remain inadequately resolved. The indistinct boundary between FDI and FPI particularly in cases involving convertible instruments or incremental equity accumulation creates scope for regulatory arbitrage, enabling investors to structure transactions to avoid more onerous regulatory categories. The divergence in enforcement mechanisms SEBI's quasi-judicial framework versus FEMA's administrative adjudication further magnifies the consequences of this fragmentation.

Procedural Delays and Lack of Transparency

Despite operationalisation of the FIFP¹³ as a single-window interface, the Government Route continues to suffer delays from inter-ministerial consultations and undefined timelines, increasing transaction costs and deterring time-sensitive investment decisions. Administrative determinations on FDI applications are typically unpublished and unaccompanied by detailed reasoning, unlike SEBI's accessible and reasoned orders. This opacity undermines accountability and restricts legal challenge. The structural absence of a formal appellate

¹² *SEBI v Rakhi Trading Pvt Ltd*, (2018) 13 SCC 753.

¹³ DPIIT, Standard Operating Procedure for Processing FDI Proposals (FIFP).¹⁶ Foreign Exchange Management (Non-Debt Instruments) Rules, 2019.

mechanism for rejected FDI proposals entrenches this deficiency. The criteria applied in sensitive sectors particularly those invoking national security are disclosed neither in general nor specific terms, generating an environment structurally indistinguishable from arbitrariness.

Compliance Gaps and Post-Approval Monitoring Deficiencies

The FDI framework exhibits pronounced loopholes in post-approval monitoring and compliance enforcement. Heavy reliance on investor self-reporting¹⁶ without independent contemporaneous verification creates vulnerability to non-disclosure and strategic underreporting. The beneficial ownership challenge is particularly acute: multi-layered corporate structures and offshore vehicles enable systematic obscuring of ultimate ownership, potentially circumventing sectoral restrictions. The absence of integrated data-sharing among regulators means SEBI's surveillance intelligence is not consistently integrated with FEMA enforcement. Enforcement under FEMA is predominantly penal and retrospective, permitting non-compliant structures to operate for extended periods before detection. The differential treatment of listed and unlisted entities creates structural incentives to channel investments through unlisted vehicles to avoid stricter scrutiny.

SEBI JURISPRUDENCE ON FOREIGN INVESTMENT

SEBI's jurisprudence occupies a pivotal position in shaping the practical contours of foreign investment regulation, yet a critical examination reveals persistent inconsistencies and interpretational lacunae most notably in the treatment of beneficial ownership, disclosure obligations, and indirect acquisitions.

In *SEBI v Rakhi Trading Pvt Ltd*¹⁴, the Supreme Court unequivocally upheld SEBI's authority to penalise fraudulent trading practices, affirming its capacity to intervene against complex structures deployed to subvert market integrity. Nevertheless, SEBI's engagement with foreign investment structures particularly participatory notes (P-notes) and offshore derivative instruments has lacked doctrinal uniformity. The inability to consistently trace ultimate beneficial ownership through such instruments has produced identifiable regulatory blind spots, permitting foreign investors to operate with anonymity that may facilitate circumvention of sectoral caps or entry restrictions.

¹⁴ *SEBI v Rakhi Trading Pvt Ltd*, (2018) 13 SCC 753.

The question of beneficial ownership and control has emerged as a recurring unresolved challenge. Under the SEBI (Substantial Acquisition of Shares and Takeovers) Regulations, 2011¹⁵, disclosure obligations are triggered upon crossing prescribed shareholding thresholds and acquiring control, yet determining "control" in indirect or layered investment structures has resisted consistent resolution. SEBI's interpretative approach has varied materially across cases. In *Clariant International Ltd v SEBI*¹⁶, the SAT advocated a purposive interpretation of takeover regulations, partially clarifying certain definitional aspects while simultaneously illuminating the limitations of existing definitions in capturing effective control exercised through modern investment arrangements.

SEBI's handling of insider trading violations involving foreign investors under the SEBI (Prohibition of Insider Trading) Regulations, 2015¹⁷ reflects predominantly reactive and casespecific enforcement, constrained by jurisdictional boundaries and the practical challenges of cross-border evidence gathering. SEBI's reliance on case-by-case adjudication rather than codified principles contributes materially to regulatory uncertainty, preventing development of the stable normative standards that investors require. The structural divergence in enforcement mechanisms between FEMA and SEBI administrative adjudication versus quasi-judicial proceedings with structured appellate oversight produces differences in procedural safeguards and divergent interpretative traditions that operate without meaningful coordination, ultimately reflecting a tension between regulatory adaptability and the imperative of legal certainty.

POST-APPROVAL COMPLIANCE AND ENFORCEMENT ISSUES

The effectiveness of the FDI regime cannot be assessed solely by its approval mechanism; it must equally be evaluated by the robustness of its post-approval compliance and enforcement framework. The post-approval phase is characterised by identifiable systemic deficiencies in monitoring, enforcement, and inter-institutional coordination that materially undermine the integrity of the overall regulatory regime.

The foundational vulnerability derives from its architecture of investor self-reporting¹⁸. Foreign investors and investee entities discharge compliance obligations principally through Form FC-

¹⁵ SEBI (Substantial Acquisition of Shares and Takeovers) Regulations, 2011.

¹⁶ *Clariant International Ltd v SEBI*, (2004) 8 SCC 524.

¹⁷ SEBI (Prohibition of Insider Trading) Regulations, 2015.

¹⁸ Foreign Exchange Management (Non-Debt Instruments) Rules, 2019. ²² Foreign Exchange Management Act, 1999.

GPR and FC-TRS filings, rendering the regulatory framework structurally dependent on the accuracy and good faith of regulated party disclosures. The absence of independent, contemporaneous verification creates a systemic condition where violations undervaluation of instruments, delayed reporting, non-disclosure of beneficial ownership may remain undetected during the critical post-investment period.

The challenge of beneficial ownership identification remains intractable. Multi-tiered corporate arrangements and offshore vehicles are frequently calibrated to ensure no single entity triggers disclosure thresholds, while the aggregate structure vests effective control in an undisclosed ultimate owner. The regulatory machinery premised on voluntary disclosure without crossborder verification capability cannot penetrate such arrangements systematically or in timely fashion.

The absence of effective coordination and data-sharing among the RBI, SEBI, and administrative ministries means market surveillance intelligence is not integrated with FEMA compliance monitoring, producing enforcement lacunae readily exploitable by investors whose conduct implicates multiple regulatory domains simultaneously. Enforcement under FEMA is retrospective and penal in character²², permitting non-compliant structures to cause substantial harm before regulatory intervention. The differential treatment of listed and unlisted entities creates structural incentives for regulatory arbitrage: while SEBI imposes comprehensive obligations on listed companies, unlisted entities receiving foreign investment are governed by comparatively less rigorous FEMA and Companies Act, 2013¹⁹ standards. Technology-driven surveillance mechanisms remain limited in scope and insufficiently integrated across institutions, reflecting the absence of a centralised digital monitoring infrastructure for foreign investment transactions²⁰.

CRITICAL ANALYSIS OF REGULATORY DEFICIENCIES

The foregoing analysis establishes that the loopholes pervading India's FDI approval mechanism are manifestations of deep-seated structural deficiencies arising from fragmented governance, disproportionate dependence upon delegated legislative instruments, and the sustained absence of a unified doctrinal framework capable of governing the full spectrum of

¹⁹ Companies Act, 2013.

²⁰ SEBI (Listing Obligations and Disclosure Requirements) Regulations, 2015.

foreign investment activity coherently and predictably.

A foundational concern is the overreliance upon executive instruments²¹ the Consolidated FDI Policy, RBI master directions, press notes, and administrative circulars as primary vehicles for substantive investment regulation, in the absence of a comprehensive statutory code. While FEMA provides the broad legislative framework, operative regulatory content is contained in instruments subject to executive amendment without parliamentary scrutiny, producing a normative environment that is formally adaptable but fundamentally unstable, imposing disproportionate compliance burdens and undermining institutional legitimacy.

The failure to achieve regulatory harmonisation between FEMA and SEBI represents a second critical deficiency. The co-existence of two regimes one governing capital flows, the other market conduct without a clearly articulated hierarchy of norms or formal conflict-resolution mechanism generates persistent jurisdictional ambiguity, most acutely in transactions involving indirect acquisitions, convertible instruments, and hybrid securities. The discretionary character of the Government Route further reflects systemic weakness: while some discretion is inevitable in sectors engaging national security considerations, its exercise without publicly accessible, legally binding criteria and meaningful appellate scrutiny cannot satisfy minimum rule of law requirements.

From an enforcement perspective, the framework exhibits a pervasive reactive orientation fundamentally misaligned with the demands of contemporary investment governance. Both FEMA and SEBI mechanisms are predominantly activated in response to identified violations, with limited capacity for anticipatory risk-based supervision structurally inadequate in an environment where complex cross-border arrangements may circumvent requirements before authorities can intervene. The structural disparity in regulatory treatment between listed and unlisted entities functions as a structural inducement to regulatory arbitrage, requiring recalibration based on the nature of investment activity and associated systemic risk rather than the adventitious circumstance of public listing.

Jurisprudential inconsistency across SEBI and SAT decisions compounds these deficiencies. The absence of precise statutory definitions for "control," "beneficial ownership," and "indirect acquisition"²² has generated adjudicatory practice characterised by varying interpretative

²¹ Foreign Exchange Management Act, 1999; Consolidated FDI Policy, Government of India (latest edition).

²² *Clariant International Ltd v SEBI*, (2004) 8 SCC 524.

approaches resisting principled reconciliation. Finally, institutional fragmentation and the absence of meaningful inter-agency coordination in information sharing, enforcement, and doctrinal harmonisation collectively constitute a structural loophole of considerable magnitude. Remedying these deficiencies demands not incremental procedural adjustments but a fundamental reconceptualization of the regulatory architecture to ensure coherence, transparency, and predictability.

CONCLUSION

The critical analysis undertaken in this paper establishes with doctrinal and structural specificity that India's FDI regulatory regime under FEMA and SEBI while architecturally comprehensive in formal design is systematically undermined by entrenched loopholes that are structural rather than incidental in origin. These do not arise from isolated administrative failures or inadvertent legislative omission; they are the product of deeper and interrelated deficiencies in the design, coordination, and enforcement of the framework governing one of the most consequential dimensions of India's economic engagement with the global financial system.

A principal finding is that the dual-route approval mechanism, though conceptually well-calibrated, suffers fundamental operational deficiencies. The Automatic Route's dependence upon *ex post facto* self-reporting without commensurate verification creates structural regulatory opacity during the critical post-investment period. The Government Route is beset by the absence of codified approval criteria, procedural delays from inter-ministerial fragmentation, a deficit of reasoned decision-making, and the expansion of policy-driven discretion without corresponding legal constraints cumulatively detracting from transparency, consistency, and rule of law credentials.

The study demonstrates that concurrent regulatory jurisdiction among the RBI, SEBI, and administrative ministries, in the absence of a harmonised normative framework or effective inter-institutional coordination, generates jurisdictional ambiguity and enforcement inconsistencies systematically exploitable by sophisticated investors. The unresolved tension between FEMA's capital flow governance and SEBI's market conduct regulation particularly in transactions involving convertible instruments and indirect acquisitions requires deliberate legislative and institutional reform rather than adjudicatory intervention alone. SEBI jurisprudence, while consequential in advancing market integrity, has not achieved doctrinal

consistency necessary for reliable normative guidance on foreign investment-related issues, with varying interpretations of control and beneficial ownership generating compliance uncertainty antithetical to legal certainty.

The post-approval compliance framework emerges as the most critically underdeveloped dimension of the regime. Self-reporting dependence, limited beneficial ownership verification capacity, fragmented inter-agency data sharing, and predominantly penal retrospective enforcement collectively produce a monitoring infrastructure structurally inadequate to the challenges of modern cross-border investment. The differential treatment of listed and unlisted entities creates structural incentives for regulatory arbitrage that the existing legal architecture cannot neutralise.

Effective remediation demands, at minimum: consolidation of foreign investment legislation into a unified statutory code replacing the proliferation of executive instruments; establishment of a formal inter-regulatory coordination mechanism among the RBI, SEBI, and relevant ministries; codification of objective and published criteria governing Government Route approvals with a structured appellate mechanism; and development of a proactive, risk-based compliance monitoring framework capable of identifying violations at the earliest practicable stage. India's ambitions as a premier destination for global foreign investment can only be sustainably realised if the regulatory framework commands investor confidence, the coherence demanded by the rule of law, and the institutional capacity required for effective enforcement. The present analysis demonstrates that, in each of these respects, significant and urgent work remains to be done.