
REGULATION OF FOREIGN DIRECT INVESTMENT IN INDIA: A CRITICAL ANALYSIS OF THE FEMA FRAMEWORK

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“Markets work best where there is both freedom and the rule of law.”

- Niall Ferguson

ABSTRACT

Foreign Direct Investment (FDI) has a major role in pushing economic growth, industrial expansion, technological progress, and global integration, especially in developing countries like India. After the economic reforms of 1991, India moved toward liberalization, privatization, and globalization, and that shift changed the country into one of the leading destinations for foreign investment. This research paper studies the development and regulatory structure of FDI in India under the Foreign Exchange Management Act, 1999 (FEMA). It also follows the historical shift from the restrictive Foreign Exchange Regulation Act, 1973 (FERA) to the much more liberal, management-based FEMA framework.

Further, the paper looks at the constitutional basis of FDI regulation, including legislative competence under the Seventh Schedule, the place of fundamental rights, directive principles, and treaty-making powers. It discusses the main legal instruments governing FDI, mainly FEMA, the Foreign Exchange Management (Non-Debt Instruments) Rules 2019, the Companies Act, 2013, and the Competition Act, 2002. Along with this, the study examines the route-based approval system for foreign investment, covering the automatic route, the government approval route, and sectors where investment is prohibited.

A strong focus is placed on the key problems tied to FDI regulation under FEMA. These include regulatory complexity, procedural delay, compliance pressure, sectoral caps, data localization requirements, restrictions on investments from land-bordering countries, and a compliance framework that keeps changing and often creates frustration. The paper concludes that even though India has clearly liberalized its FDI regime in a big way, stronger

regulatory clarity, consistency, and coordination are still needed to create a stable and genuinely investor-friendly environment.

Keywords: Foreign Direct Investment (FDI), Foreign Exchange Management Act (FEMA), Economic Liberalisation, FDI Regulatory Framework, Investment Policy in India.

I. INTRODUCTION

Foreign Direct Investment has proved to be an important ingredient in the economic development process of countries, especially for those developing nations that have chosen sustainable growth and participation in the international market environment as their goals¹. Foreign direct investment consists of investments made either individually, corporately, or through any business entity from one nation to a commercial entity operating in another nation to establish a business presence there and exert some level of management control. This differs from portfolio investment in that foreign direct investment establishes a long-term association between the investor and the business entity, involving not just the inflow of capital, but also technology and management skills². In today's globalized economy, FDI has become increasingly relevant due to its potential in fostering industry development, job creation, increasing efficiency, and improving infrastructure. The role of foreign firms in the development of the economy of the recipient country is evident when considering the various ways in which they can contribute, such as through greenfield investments, mergers and acquisitions, and joint ventures, among others. The influx of investments from other countries is particularly useful to developing countries since they require capital for development.

The importance of FDI was realized in India following the economic liberalization policies that were adopted in the year 1991³. Liberalization, privatization, and globalization policy changed the entire Indian economic scenario by eliminating any form of hindrances and making the country open to foreign participation in various industries. Thus, there has been a drastic change in the policy of India's economy. Now India is counted among the leading destinations in foreign investments for various sectors like manufacturing, telecommunication, pharmaceuticals, information technology, retail, infrastructure, and energy because of its huge

¹ Sornarajah, M. (2017). *The international law on foreign investment* (4th ed.). Cambridge University Press.

² Organization for Economic Co-operation and Development. (2008). *OECD benchmark definition of foreign direct investment* (4th ed.). OECD Publishing.

³ Government of India. (1991). *Statement on industrial policy*. Ministry of Industry.

consumer base, trained workforce, increasing industrialization, and favorable business atmosphere.

An important development with respect to the regulatory policy of FDI in India can be seen in the form of the emergence of several laws and policy guidelines issued by the government to make the entire process smooth. These include the Foreign Exchange Management Act, 1999 (FEMA) and guidelines of the Department for Promotion of Industry and Internal Trade (DPIIT)⁴. There are other specific regulations, too, regarding different sectors. Several policies of the government have led to the creation of a better business environment and encouraged domestic manufacturing. However, foreign investments also pose legal, economic, and policy challenges that need to be considered. Aspects concerning competition in the market, national economic interests, control in specific industries, and regulations need to be considered. Thus, any regulations for FDI should ensure that foreign investments contribute to economic development but do not destabilize the economy.

II. HISTORICAL EVOLUTION OF INDIA'S FOREIGN DIRECT INVESTMENT REGULATORY REGIME

Pre-Liberalization Era (1947-1991)

Post-independence India followed a controlled economy system based on the principles of selfreliance, import substitution, and public sector domination. As per the Industrial Policy Resolutions 1948 and 1956, major industries in the country were put under state control, and there was tight monitoring of private and foreign investments. During this time, foreign investments were viewed in a negative light because it was believed that an excess of foreign ownership could pose a risk to India's economic autonomy.

A notable act regulating foreign investments at this time was the Foreign Exchange Regulation Act, 1973 (FERA)⁵. The FERA Act imposed strict controls on foreign currency dealings, profit remittances, and foreign shareholding of Indian firms. Generally, foreign companies had to lower their shareholdings in Indian firms to a maximum of 40 per cent. Due to the stringent

⁴ Department for Promotion of Industry and Internal Trade. (2020). *Consolidated FDI policy circular 2020*. Ministry of Commerce and Industry, Government of India.

⁵ Foreign Exchange Regulation Act, No. 46 of 1973, India Code (1973).

measures of FERA, many multinational companies such as Coca-Cola and IBM left the Indian business market by the late 1970s.

Economic Reforms of 1991: Beginning of Liberalization

1991 saw a significant turning point for India economically. The country had a balance of payments problem and its foreign exchange reserves were falling, necessitating the making of reforms, which were spearheaded by the government headed by P. V. Narasimha Rao, who got significant assistance from Manmohan Singh, his economic advisor, in formulating the policy reforms. The reforms led to the implementation of the LPG policy, that is, liberalization, privatization, and globalization of the Indian economy⁶, making it more open to foreign investments.

Some of the major reforms included the use of the automatic route, where foreign investment in some identified sectors would not require any prior approval. The establishment of the Foreign Investment Promotion Board, tasked with examining applications requiring approval, was also one of the reform policies implemented. To begin with, foreign equity up to 51% was permitted in various priority sectors, and this number was later increased to include more sectors such as energy, telecommunications, infrastructure, and manufacturing.

Transition from FERA to FEMA (1999–2000)

One important change in the FDI legislation of India was that FERA was replaced by the Foreign Exchange Management Act 1999 (FEMA), implemented from 1 June 2000⁷. FEMA is a revolutionary change in the Indian regulatory regime. Unlike FERA, which considered offences to be criminal, FEMA took a totally different perspective towards foreign investments. FEMA is completely based upon a civil and administrative approach, aiming at managing foreign exchange transactions and foreign trade.

In FEMA, differentiation has been made between transactions under the capital account and those under the current account. The RBI has been empowered with the responsibility of managing foreign exchange transactions.

⁶ Datt, R., & Sundharam, K. P. M. (n.d.). *Indian economy*. S. Chand Publications.

⁷ Foreign Exchange Management Act, No. 42 of 1999, India Code (1999).

Foreign Exchange Management (Non-Debt Instruments) Rules, 2019, Gazette of India (2019).

Contemporary Liberalization and Sectoral Expansion

With the introduction of FEMA, the FDI policy in India became gradually more liberalized in several sectors. Gradually, caps on foreign investments in sectors including defense, insurance, civil aviation, retail, construction, railways, and space technology increased. Currently, the FDI policy in India is mainly guided by the Foreign Exchange Management (Non-Debt Instruments) Rules of 2019, together with the Consolidated FDI Policy published by DPIIT.

In recent reforms, foreign participation in several strategic sectors has also been increased. For example, in 2026, India permitted 100 per cent FDI participation in its insurance sector through the automatic route, doing away with the previous limit of 74 per cent. These are some of the instances showing that India has transformed into one of the most liberal FDI destinations in the world from being among the most restrictive countries.

III. CONSTITUTIONAL FOUNDATIONS OF FDI REGULATIONS

Distribution of Legislative Competence

The seventh schedule of the Constitution, which distributes the legislative authority between the Central and State Governments in accordance to the Union List (List I), State List (List II), and Concurrent List (List III), is the principal source of the legal authority to regulate foreign investments. Various articles in the Union List are directly relevant to regulating FDI.

Article 36 of the Union List confers sole legislative powers of Parliament in respect of 'currency, coinage and legal tender; foreign exchange.' Article 36 provides the constitutional legitimacy to enact the Foreign Exchange Management Act, 1999 (FEMA), the key statute for managing foreign exchange dealings, such as the entry, tenure, and withdrawal of foreign funds.

Articles 43 grants parliamentary jurisdiction over the 'incorporation, regulation and winding up of trading corporations, including banking, insurance and financial corporations, but not including co-operative societies,' whereas Article 44 grants powers for the incorporation, regulation and winding up of corporations, 'whether trading or not, with objects not confined to one State.'

The following table summarizes the key Seventh Schedule entries bearing upon FDI regulation:

Entry	List	Subject Matter	Relevant Legislation
Entry 36	Union List (List I)	Currency, coinage, legal tender; foreign exchange	FEMA, 1999
Entry 43	Union List (List I)	Incorporation and regulation of trading corporations	Companies Act, 2013
Entry 44	Union List (List I)	Incorporation and regulation of nontrading corporations	Companies Act, 2013
Entry 14	Union List (List I)	Entering into treaties with foreign countries	BITs / FTAs
Entry 21	Concurrent List (List III)	Commercial and industrial monopolies, combines and trusts	Competition Act, 2002
Entry 26	Concurrent List (List III)	Legal, medical and other professions	Sector-specific statutes

Table 1: Seventh Schedule Entries Governing FDI

Fundamental Rights and FDI

The policies related to FDI have a significant bearing on Article 19(1)(g) of the Constitution. Policies relating to FDI have considerable importance in terms of Article 19(1)(g) of the Constitution that defines the fundamental rights. Article 19(1)(g)¹⁰ states that citizens of India

have the right to carry out any professional, trade, business, or occupational activities. It is a right accorded only to Indian citizens and not to any foreign body. However, its interpretation by the Supreme Court suggests its applicability to foreign investments, too. It provides that all citizens of India shall have the right to carry on any profession, trade, business, or occupation. While it is true that the provision is a right conferred only upon citizens and not upon foreigners, it has been held by the Supreme Court to include Indian parties in joint enterprises and foreign companies as well.

Article 19(6) of the Constitution authorizes the State to enact laws to impose reasonable restrictions on the right provided under Article 19(1)(g), if such restrictions are in the interest of the general public. It also allows the State to operate its own businesses to exclude citizens from engaging in similar professions. Such provisions have been used as grounds for sectorspecific restrictions on FDI, including the prohibition of FDI in atomic energy, railways, and defense sectors.

The importance of Article 14 (right to equality before law and equal protection of laws) has gained significant prominence due to judicial consideration of whether the different treatment meted out to foreign and domestic investors would violate the constitutional right of equal protection. The judicial consensus, in the light of the judgments of the Supreme Court in *R.D. Shetty v. International Airport Authority (1979)*¹¹ and *Ramana Dayaram Shetty v. International Airport Authority (1979)*, holds that Article 14 applies to all persons, Indians or foreigners, including companies, although it does not prohibit classification.

Article 300A was introduced in the Constitution by the Constitution (Forty-Fourth Amendment) Act, 1978. This article states that no person can be deprived of their property without the authority of law. Although it ceased to be a fundamental right, it is still a significant constitutional right for foreign investors in the face of expropriation and nationalization claims.

Directive Principles and the Developmental Dimension

The Directive Principles of State Policy (Part IV) make a constitutional obligation on the part of the state to conduct its economic policy towards achieving a 'social order in which justice, social, economic and political shall inform all institutions of national life' (Article 38). Articles 39(b) and (c) further provide for ensuring that the material resources of the community are so distributed as to subserve the common good, and that wealth is so distributed that no section of

society is deprived to the detriment of others. These articles have been used in judicial discourse to legitimize conditionalities imposed as a result of FDI in terms of local content and technology transfer.

In the case of *State of Karnataka v. Ranganatha Reddy* (1977) and *Sanjeev Coke Manufacturing Company v. Bharat Coking Coal Ltd.* (1983), the Supreme Court held that Article 39(b) is indeed a justification for regulating the economy in a distributive sense, even if it violates individual property rights.

Treaty-Making Power and International Obligations

According to Article 73, the executive power of the Union extends to all matters in relation to which Parliament has power to make laws. As the regulation of foreign exchange and the registration of foreign companies have been included in the Union List, the Union Government is endowed with wide executive powers for negotiation and execution of investment treaties.

It must, however, be noted that, unlike many other federal constitutions, the Indian Constitution lacks a self-executing provision about the treaties executed by the country.

In this context, it must be noted that the provisions of the treaties become part of domestic law only after their implementation by the Parliament of India. This aspect of the Indian legal system is crucial in determining the efficacy of India's BITs. In *Vishaka v. State of Rajasthan* (1997)¹², the Supreme Court ruled that in case there is a vacuum in domestic law, conventions that have been ratified by India can be invoked to interpret laws. As far as investments are concerned, BITs serve as vital interpretive guidelines regarding national treatment, most-favored nation treatment, fairness and equitable treatment, and non-expropriation.

IV. PRINCIPAL LEGISLATIVE INSTRUMENTS GOVERNING FDI

The Foreign Exchange Management Act, 1999

The FEMA, 1999, forms the bedrock of the FDI regulation framework in India. The FEMA, enacted in replacement of the stringent FERA, 1973, is a radical departure from the control regime towards an entirely new concept of management. Under the FERA, 1973, all foreign exchange dealings were per se illegal and required specific authorization; whereas, FEMA

makes the presumption in respect of current account activities to be otherwise, and the transactions in the capital account, including FDI, are regulated by rules and notifications.

Foreign exchange has been defined under Section 2(1) of FEMA as foreign currency, deposit, credit or balance payable in foreign currency, along with drafts, traveler's cheques, letters of credit and bills of exchange drawn in Indian currency and payable in foreign currency. It is further provided under Section 6 of FEMA that the RBI, after consultations with the Central Government, may determine the classes of capital account transactions permissible and up to what limit they can be done. These provisions have laid down the foundation of the delegation laws, namely, Foreign Exchange Management (Non-Debt Instruments) Rules, 2019, relating to FDI.

The shift from FERA to FEMA has also seen a major shift in enforcement, wherein FERA violations were considered criminal offences, while FEMA violations are now considered civil offences punishable by fines. The shift was specifically meant to lessen the deterrence that regulatory uncertainty creates on foreign investments, as well as make India's foreign exchange laws conform to international norms.

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

The Foreign Exchange Management (Non-Debt Instruments) Rules, 2019, issued under FEMA, represent the major legal regulation that specifies limits on the number of investments from foreign sources, modes of access, and associated conditions. According to the Rules, the investment in Indian sectors falls into two main categories: investment falling under the Automatic Route, where foreign investment in India will not need any permission from the government; and the Government Route, where approval from the Government of India will be required (the government department, through which this permission is received, would be a relevant department or ministry).

FDI Policy Circular, being regularly compiled and published by DPIIT (previously known as DIPP), represents a significant document which comprehensively reflects the Rules and their implementation; however, it should be noted that this circular acquires its obligatory force on account of the underlying FEMA Rules and Regulations.

The Companies Act, 2013

The Companies Act, 2013, deals with the incorporation, governance, and winding up of companies in India. The significance of this legislation in relation to FDI cannot be overstated, as most FDI investments made into the Indian market take the form of investments into Indian companies. Relevant clauses are those of Chapter XX (liquidation/winding up), those dealing with transactions with related parties (Sections 177 and 188), those concerning wholly owned subsidiaries and joint ventures, and those relating to profit/dividend repatriation.

There have been major changes in the Act in 2013 which directly affect foreign investors, such as those concerning mandatory provisions at the level of the company's board of directors (at least one resident director), mandatory corporate social responsibility obligations for large firms, and stronger rights for minority shareholders.

The Competition Act, 2002

The Competition Act, 2002, which is controlled by the Competition Commission of India (CCI)⁸, provides an overlay of competition law to FDI investments. Section 5 of the said Act requires mandatory threshold notifications for combinations (merger, acquisition, and amalgamation), irrespective of whether the acquirer is a foreign entity. The Act prohibits the existence of anti-competitive agreements (Section 3) and abuse of dominant position (Section 4) and applies such prohibitions to enterprises with foreign investment working in India.

It is pertinent that the issue has grown even more relevant in recent years because of many acquisitions made by multinational enterprises in India. This can be attributed to the review conducted by the CCI regarding the Amazon and Future Retail combination (CCI Order, 2021).

Sector-Specific Legislation

In addition to these general laws, there is a sizeable set of industry-specific laws that regulate FDI in specific sectors. In this connection, reference may be made to the Insurance Act, 1938, and the Insurance Regulatory and Development Authority of India Act, 1999, which deal with FDI in insurance, the ceiling of which was raised through the Insurance (Amendment) Act, 2021, to 74 per cent. The Banking Regulation Act, 1949, regulates foreign investments in

⁸ Competition Act, No. 12 of 2003, India Code (2003).

banking. About telecommunication, the laws are the Telecom Regulatory Authority of India Act, 1997, and the recently enacted Telecommunications Act, 2023, which consolidates previous enactments. Foreign investment in atomic energy is not permitted under the Atomic Energy Act of 1962. In the case of mining, the relevant law is the Mines and Minerals (Development and Regulation) Act, 1957.

V. ROUTE-BASED APPROVAL MECHANISM FOR FDI IN INDIA

The FDI policy in India permits foreign investors to invest in Indian businesses via various approval processes. The approval process is based on a route system, which helps to identify whether the foreign investor can make investments without any prior approval or needs to obtain approval from the Government of India before making such investments. The major provisions for the route-based FDI approval process are the FEMA, consolidated FDI policy, and RBI regulations⁹.

Automatic Route

Investment in India under the automatic route does not need prior clearance from the Government of India or the RBI to invest in India. They can invest directly based on various ceilings, pricing policies, and other conditions as laid down under the FDI scheme. Upon investing, the Indian company should inform the RBI about this transaction within a prescribed period.

Most of the sectors in India follow the automatic route policy in order to make things convenient for foreign investors and bring in foreign capital into the country. This includes the manufacturing industry, information technology, e-commerce marketplace model, renewable energy sources, and some of the infrastructure-related activities, among others. For example, 100% FDI is permitted under the automatic route in many cases of manufacturing activities.

Government Approval Route

In the case of the route through government, it is essential that prior approval be obtained from the Government of India before initiating foreign investment. It is the process of obtaining

⁹ Reserve Bank of India. (n.d.). *Master directions on foreign investment in India*. Reserve Bank of India.

these approvals that gets done via the relevant ministry or department, mostly in collaboration with the DPIIT.

This route is adopted in those sectors where the investment is considered sensitive in terms of national security, strategic importance, or other public interest considerations. Such sectors could include defense, print media, multi-brand retail trading, and some telecom/broadcasting operations beyond certain levels. For instance, in the defense sector, any foreign direct investment above a certain level could require permission from the government on account of national security and strategic considerations of the nation. Permissions are sought through the Foreign Investment Facilitation Portal (FIFP).

Prohibited Sectors

Certain industries or sectors cannot receive FDI at all, under any circumstances. Such sectors are: (i) lottery industry, both governmental and private, including online lottery; (ii) gambling and betting, including casinos; (iii) chit funds; (iv) Nidhi companies; (v) TDR trade; (vi) real estate business or construction of farm houses; (vii) production or manufacture of cigars, cheroots, cigarillos and cigarettes, whether or not containing tobacco or any other substance in place of tobacco; (viii) industries or activities not permissible to the private sector like atomic energy and railway; and (ix) foreign technology collaboration in any form including franchisee license, trademark license, brand name license, and management contract is also prohibited for the lottery business and gambling and betting industries.

The reasons behind imposing prohibitions include public morality, national security, and financial institutions in the country. The prohibition on FDI in the real estate business has sometimes created ambiguity, where courts were required to determine the difference between 'real estate business' (which is prohibited) and construction developments, hotel and tourism projects, industrial park projects and many more.

V. ANALYSIS OF GLOBAL INVESTMENT IN INDIA

The table mentioned below give a clear comparison of the main countries investing in India through FDI, showing each one's share, the sectors they focus on, and how they contribute to India's economic and industrial growth¹⁰.

¹⁰ United Nations Conference on Trade and Development. (2023). *World investment report 2023*. United Nations

Rank	Country	2022–23 (₹ Crore)	2023–24 (₹ Crore)	2024–25* (₹ Crore)	Cumulative Inflow (2000–2024) (₹ Crore)	Share in Total FDI
1.	Mauritius	48,895	66,147			
				58,363	10,80,953	25%
2	Singapore	1,37,374	97,475	1,00,577	11,92,450	24%
3	United States	48,666	41,403	31,330	4,78,647	10%
4	Netherlands	19,855	40,733	34,040	3,58,22	7%
5	Japan	14,328	26,243	11,423	2,73,727	6%
6	United Kingdom	13,994	10,061	4,747	2,08,042	5%
7	United Arab Emirates	26,315	24,262	34,767	1,65,988	3%
8	Cayman Islands	6,069	2,835	2,473	1,10,388	2%
9	Germany	4,417	4,181	2,731	90,605	2%
10	Cyprus	10,184	6,705	9,900	89,356	2%

Table 2: Data Analysis and Interpretation

VI. CONCLUSION

Foreign Direct Investment has become a major force in India's economic growth, industrial development, and its deeper connection with the global market. The shift from the strict system under FERA to the more flexible framework created by FEMA clearly shows India's attempt to welcome foreign investment without giving up regulatory control or national interest. Over time, reforms in sectoral rules, legal provisions, and approval processes have brought more foreign participation into many parts of the economy. Even then, the FDI regulatory structure still carries real problems. Regulatory uncertainty remains, approvals can take too long, and compliance demands are often heavy. On top of that, some sectors still face tight restrictions, data localisation rules add pressure, and policy changes happen too often, which is frustrating for investors. Extra complications also come from limits on investment from neighbouring countries and the rules around downstream investment. Overall, India needs stronger transparency, more consistent regulation, and better coordination between institutions if it wants a stable investment climate that supports investors and protects public welfare.

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