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**"ANALYSING THE ROLE OF DIFFERENT REGULATORY AUTHORITIES IN
SHAPING UP OF FDI POLICIES IN INDIA."**

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I. ABSTRACT:

"Since 1991, India has witnessed drastic changes and reforms in its economic policies with the goal of providing investment opportunities to private and foreign players. With the advent of globalization, India does not want to lag behind in the race of attracting foreign investment. Foreign Direct Investment (FDI) has become one of the important tools for the economic development of the country. It is agreed upon that the opportunity costs of maintaining foreign exchange reserves are indeed material and cannot be brushed aside, more so by developing countries.

The scheme of this article will focus on the challenges faced by India regarding its foreign investment policies and the role of financial market regulators as well as a government while dealing with such encounters. A qualitative approach has been adopted for this research. Some important Case Laws, Committees and Reports are discussed which has played a major role in defining the rules adopted by regulatory authorities pertaining to foreign investment."

II. INTRODUCTION:

During the post-independence period from 1950 to 1960, the state was the major investor in the public sector. The concept of closed economy as used by the Soviet Union was

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introduced in India by P.C. Mahalanobis. As India was not open for trade from the outside world, therefore rapid growth relied on domestically produced capital goods. The policy focused on investing in such capital goods. This becomes the basis on which state would one hand control private player in entering into the capital market and rather made the public sector into capital intensive zone.

In 1956-57, there was an issue with the balance of payment which was dealt with by controlling imports. This gave bureaucrats discretionary power, as the clearance for import was in their hands. The deciding factors were firstly, whether there is any “substitute good” to imported good is available domestically, and secondly whether the imported good was “really essential”. The growth rate during this time, period was not up to the target that India was hoping for, but at the same time it was better than the pre-independence era. On the other end in the newly industrialised world, other neighbouring nations grew fast during this period with help of an increase in exports. Whereas, India was not well suited for competition with these countries.

During the mid-1970s, the growth rates were unavoidably low and yet policymakers' main focus was to benefit the poor. “The fifth five-year plan stipulated a lower growth target of 4.4% and emphasised self-reliance to deal with the balance of payments problems”.¹

This slow pace of growth rate was acceptable to the policy makers as the main area of concern during the mid-70s was to benefit poor. It was only after the emergency period (which was ended by Indira Gandhi), real restructuring of the Indian economy commenced. During a short period under the leadership of Morarji Desai (the first Indian P.M. who did not belong to Congress), little market-friendly policies introduced in India. But socialist like George Fernandes forced Coca Cola and IBM to dilute equity up to 40% or leave India, which were not so friendly moves.² Desai was replaced by Chaudhary Charan Singh in July 1979. The main concern of Chaudhary Charan Singh was to grow the agriculture sector.

¹ Montek S. Ahluwalia, *The 1991 Reforms how home-grown were they?*, 51 ECONOMIC AND POLITICAL WEEKLY, 40, 39- 46, July 16, 2016.

² Nigel Hollis, *The Global Brand : How to Create and Develop Lasting Brand Value in the World Market*, MILLWARD BROWN, pg. at 49, 2008

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Many committees were called upon to pave the path of Liberalisation, increase competitiveness and overall growth during the 1970s to 1980s. One such committee was '*Committee on Import-Export Policies and Procedures*' which was set up in 1977 and chaired by *P.C. Alexander*.³ Few of its recommendations were:

- To widen up the scope of Open General License so as to increase imports;
- Reduce tariffs;
- Not to consider import as a negative element while scheming Balance of Payments;
- Liberalising licensing policies for imports;
- Subsidies provided in exports to be reduced to a minimal level and should become competitive;

In 1978-79, *Vadilal Dagli* chaired *Committee of Control and Subsidies of Government of India*.⁴ But the committee failed at providing any recommendations to change the control system. Instead, it was observed by the committee that the import controls or the licensing controls were justified and just needed a review by ministries concerned. Therefore, it left the power of review again under the control of ministerial administering authorities.

During the mid-1980s, two of the major sectors of the economy, i.e., agriculture and industrial sector witnessed a very slow growth. *Isher Judge Ahluwalia* observed that the low growth in industries was not just because of low investment in infrastructure but also because of control on investment in this sector. She pointed out it was time for India to come out of the protectionist approach and change the policies accordingly.⁵ Some of the other significant committees were- '*The Abid Hussain Committee on Trade Policy*',⁶ '*The Narasimham Committee on the Shift from Physical to Fiscal Control*',⁷ and '*The Sengupta Committee on Public Sector Reforms*'.

³ See Infra Note 13

⁴ Vadilal Dagli, *Report of the Committee on Controls and Subsidies* (New Delhi: Ministry of Finance, 1978)

⁵ See, Ahluwalia, Isher Judge (1985): *Industrial Growth in India: Stagnation since the Mid-Sixties*, OXFORD UNIVERSITY PRESS, DELHI.

⁶ Abid Hussain (chair), *Report of the Committee on Trade Policy* (New Delhi: Ministry of Commerce, 1984)

⁷ M Narasimham (chair), *Report on Industrial Licensing and Related MRTP Aspects* (New Delhi: Ministry of Finance, 1985)

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All of these committees recommended that India should facilitate trade rather than restricting it. The consensus was also to promote public sector self-sufficiency, and there shall also be less of fiscal control over the imports in the country. This was considered necessary in order to open the Indian economy to fair competition and improve productivity as well as the efficiency of an already established market. As a result of these efforts and recommendations made by the various committees, the country could sense progress and the process of deregulation of Indian economy took place. About 32 sets of industries were delicensed. “In 1988, all industries were exempted from licensing except for a specific negative list of twenty-six industries. This exemption from licensing was, however, subjected to investment and locational limitations.”⁸

Various steps were taken by Narasimha Rao committee to liberalise the economy under the administration of Rajiv Gandhi. Yet there were still few restrictions on domestically produced goods and its exports.⁹

With the objective of strengthening the banking system and liberalising banking sector, it was recommended by “Narasimham Committee on Banking Reforms in 1998” that the capital holding by RBI/Government shall be reduced to 33% from 51%.¹⁰

To regulate Capital issues and stock exchange, SEBI was established in the year 1992. As a result of transformation in the economic policies and transfer of regulatory functions to SEBI, notable GDP growth was sensed by India in former years. Though, it has been argued by J Bradford Delong that this growth was not the result of liberalisation per se but it was an outcome of the change in the government’s attitude towards control system.¹¹ Hence, the government had the control and it was still operating it in a different manner.

⁸ Puja Mondal, *Recommendations of the PC Alexander Committee on Indian Trade Policies*, last visited on 2nd March, 2017, available at: <http://www.yourarticlerepository.com/economics/indian-economy/recommendations-of-the-pc-alexander-committee-on-indian-trade-policies/40249/>

⁹ Arvind Panagariya, *India in the 1990s and 1980s: A triumph of reforms*, IMF WORKING PAPER NO. WP/04/43, MARCH 2004, IMF.

¹⁰ Shri G. P. Muniappan, Deputy Governor, RESERVE BANK OF INDIA, *Management Challenges in Banking*, NIBM Annual Day Celebrations, January 6, 2003, Available at : https://www.rbi.org.in/scripts/BS_SpeechesView.aspx?Id=125

¹¹ J Bradford Delong, *India since Independence: An Analytical Growth Narrative, Analytical country studies* Dani Rodrik Ed., PRINCETON, PRINCETON UNIVERSITY PRESS.

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III. DEPARTMENT OF INDUSTRIAL POLICY & PROMOTION¹²:

In 1995, the “Department of Industrial Policy & Promotion” was established. “Government of India (Allocation of Business Rules), 1961” Schedule 2 Entry II.21 under the head “DIPP, Ministry of Commerce and Industry” empowers DIPP to regulate FDI policy. DIPP was reconstructed in the year 2000, when it merged with “Department of Industrial Development”. Before this union, there was a separate ministry for “Small Scale Industries & Agro and Rural Industries (SSI&A&RI)” and “Heavy Industries and Public Enterprises (HI&PE)” in 1999.¹³ With the growth towards liberalisation starting from 1991, there has been a constant change in the functioning of this department. The department used to focus on the administration and regulation of the industrial sector. This role has been transformed into monitoring industrial development, facilitation investment, ensuring technological advancement and providing liberal industrial policies. One of the main functions and role of the “Department of Industrial Policy and promotion” has been “Formulation of Foreign Direct Investment (FDI) Policy and promotion, approval and facilitation of FDI”¹⁴.

The DIPP is responsible for the pronouncement of FDI policy embodied in “Circular on Consolidated FDI policy” which is updated each year (since 2010). The motive behind this yearly update is to provide a framework of policy, which is easily comprehensible, to keep pace and to capture the regulatory changes introduced each year. The policy contains all the changes notified by ‘Reserve Bank of India’ through a number of press releases and press notes. FDI policy also includes the amendment made to “Foreign Exchange Management (Transfer or Issue of Security by Persons Resident Outside India) Regulations, 2000”.¹⁵ FEMA notification shall prevail, in case there is a conflict with the FDI policy.¹⁶ The instructions for the procedure are issued by RBI vide “A.P. (DIR Series) Circulars”.¹⁷

¹² Note: Department of Industrial Policy and Promotion (DIPP) has been changed to Department for Promotion of Industry and Internal Trade (DPIIT) vide Gazette Notification No. S. O. 507 (E) Dated 27th January 2019.

¹³ Ministry of Commerce and Industry, *Department for Promotion of Industry and Internal Trade*, GOVERNMENT OF INDIA, Available at : <https://dipp.gov.in/about-us/role-and-functions-department-promotion-industry-and-internal-trade>

¹⁴ Ministry of Commerce and Industry, *Department of industrial Policy and Promotion*, GOVERNMENT OF INDIA, Available at : <http://dipp.nic.in/English/AboutUs/Roles.aspx>

¹⁵ *Id.*

¹⁶ See, *Consolidated FDI Policy*, Ministry of Commerce & Industry, Department of Industrial Policy & Promotion, GOVERNMENT OF INDIA, June 07, 2016, Para 1.1.2

¹⁷ Authorized dealer under FEMA, 2000.

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The new FDI policy shall supersede all the other press releases, circulars, clarifications, press notes issued by DIPP before the date from which the policy has been notified.¹⁸

IV. FOREIGN INVESTMENT PROMOTION BOARD:

The “Foreign Investment Promotion Board (FIPB)” was an inter-ministerial body which works under the Department of Economic Affairs under MoF. FIPB was responsible for proposing FDI approval made through Government route.¹⁹ The guidelines notified by DIPP in the “Ministry of Commerce” like FDI policy, Press Notes etc. are based on the decision of FIPB. FIPB plays a significant role in framing a policy for FDI. During the early period of the 1990s, FIPB was constituted under the “Prime Minister Office.” The recommendations made by FIPB had to pass through a committee of a senior official and under chair of Finance Minister through Committee on Foreign Investment (in case of investment made up to Rs 300 Crore) and finally through “Cabinet Committee on Foreign Investment” (for investment of more than Rs. 300 crore).

In 1996, FIPB was reconstituted and transferred to DIPP with the approval levels based on the investment value. For projects involving an investment of worth Rs. 600 crores or less, recommendations of FIPB were considered but final approval was given by the Industry Minister. The recommendations with respect to the investment involving sum more than Rs 600 crores would be submitted to Cabinet Committee on Foreign Investment for decision. Also, a proposal rejected by the Industry Ministry may be referred to the Cabinet Committee. In 2003, FIPB was transferred to “Department of Economic Affairs; Ministry of Finance in terms of the Presidential Order.”²⁰

The approval procedure of 1996 was retained. The projects involving investment amount of less than Rs. 600 Crore were considered by the Finance and company affairs minister and the decision regarding projects worth Rs. 600 Crore or more were taken care of by the Cabinet Committee on Economic Affairs.

¹⁸ *Supra Note 2 para 1.1.3*

¹⁹ *Historical Background of FIPB, FOREIGN INVESTMENT PROMOTION BOARD, DEPARTMENT OF ECONOMIC AFFAIRS.*

²⁰ *Id.*

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FIPB procedural instructions were mentioned under the Consolidated FDI Policy of 2006.²¹

Chapter 4 provides for the Constitution of FIPB.

FIPB comprises of the following Secretaries to the Government of India:

- “Secretary to Government, Department of Economic Affairs, Ministry of Finance – Chairperson.”
- “Secretary to Government, Department of Industrial Policy & Promotion, Ministry of Commerce & Industry.”
- “Secretary to Government, Department of Commerce, Ministry of Commerce & Industry.”
- “Secretary to Government, Economic Relations, Ministry of External Affairs”²²

FIPB may also appoint other Secretaries to Government or top official of banks or financial institutions or professional experts if necessary.²³

Recommendations made by FIPB regarding the investment, which are below Rs. 5000 crore, may be considered by Minister of Finance. And for investment involving an amount more than Rs. 5000 crore, FIPB recommendations shall be considered by Cabinet Committee on Economic Affairs. Cabinet Committee may also consider proposal referred by FIPB through Minister of Finance.

A. BYCELL TELECOMMUNICATIONS INDIA PVT. LTD V. UNION OF INDIA, 2010²⁴:

Bycell Telecommunications India Pvt. Ltd, the petitioner was a private limited company. The registered office of Bycell was incorporated on 13 October 2016 at New Delhi. Bycell was a joint venture of Switzerland based company named ***M/s. Bycell holding AG*** and ***M/s. Bitcorp Private Limited***, an Indian company. Bycell wanted to start telecom operation in India. Therefore, the application for this was made to the department of telecom to issue the Unified Access Service Licence (UASL). The guidelines provided that if FDI inflow for

²¹ Consolidated FDI policy 2016, 7th June, 2016, Department of Industrial Policy and Promotion Ministry of Commerce and Industry Government of India, Chapter 4.

²² *Supra note 15*, para 4.1.1

²³ *Supra note 15*, para 4.1.2

²⁴ See *Bycell telecommunications India Pvt. Ltd v. Union of India*, (2010) 117 DRJ 327

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more than 49% is made for UASL, then FIPB approval is required for making FDI through the government route. On 17th January, 2006, Bycell AG was granted permission to purchase 74% of the equity in Bycell.

In the month of October 2007, a complaint was filed against Bycell telecom and doubt against the company's credential was raised. Bycell telecom filed for security clearance from Ministry of Home Affairs and was granted clearance.

But later in a press release, FIPB stated that the approval granted has been cancelled. In May 2009, a writ petition was filed by the petitioner stating that the cancellation issued by FIPB is a violation of the principle of natural justice as neither any clear reason was intimated to Bycell and nor any sort of notice was issued prior to cancellation.

**V. REPORT OF STEERING COMMITTEE ON FOREIGN DIRECT INVESTMENT, PLANNING COMMISSION
GOVERNMENT OF INDIA²⁵:**

Before implementation of the Tenth-Plan (2002-07), the Planning Commission set the target for 8% growth and it was observed that FDI is the key variable in doing so. In order to achieve this objective for growth through FDI, a “Steering Committee on Foreign Direct Investment” was constituted by Planning Commission. The committee examined different issues related to FDI in India. The gross capital generated by FDI in 1993 was only one per cent. In 1997, the percentage went up to four per cent. The planning commission was projecting for FDI of US\$8 billion per year (2002- 07) in order to achieve its target.²⁶ The material on which committee was relying upon was provided by DIPP, Department of Commerce, Ministry of External Affairs. It was observed by the committee that the FDI regime in India is liberal and the restrictions on FDI transactions are limited to foreign nationals but not on Indian entities or Indian nationals.²⁷ Therefore, there exists a differential treatment faced by foreign investors while dealing in the same sectors. However, a foreign entity who has set up a joint venture in India is out of the purview of such limitation which is

²⁵ Report of Steering Committee on Foreign Direct Investment, PLANNING COMMISSION GOVERNMENT OF INDIA, August 2002.

²⁶ *Supra note 19*, para 2.1

²⁷ *Supra note 19*, para 4.2.1

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set on foreign entity. But when these entities came to India for the first time, they were caught up in complex legal procedure and required numerous approvals for the same.²⁸

It was also observed by the committee that there exists a multiple approval procedure which takes a long time to process. The investor finds these tangles of bureaucracy procedure and controls very frustrating.²⁹ This is leading to the loss of confidence of investors despite India's willingness to provide a considerable opportunity for growth and market size. It was perceived by the committee that with the issue of general approval (with license) there exist the issue of clearance (such as environmental clearance) in some sector, which makes FDI policy most oppressive.

The committee was of the view that FIPB with its entire procedure from registration to final disposal as well as with communication on the official website is working through the systematic procedure and is investment friendly. The committee was of the view that the FIPB approval system is 'world class' and that the Foreign Investment Implementation Authority's (FIIA) work on resolving the issues related to investments has strengthened the framework of FDI. But FIIA encountered a great deal of problem where there were projects for which implementation was to be done by the state government. This issue was solved by FIIA by setting up regional meetings chaired by Industry Secretary.³⁰

Further, some of the recommendations made by the committee to attract more FDI inflow were:

- Empowerment of FIPB;
- Set up a quicker process of approval;
- Enactment of the new policy of FDI to integrate the aspect of foreign investment into one singular law and hence making the process easily accessible to investors;

It should be noted that the issue of differential treatment towards a foreign entity or foreign nationals was not dealt with by the committee in its recommendation. But now, FIPB was

²⁸ *Supra note 19*, para 4.2.2

²⁹ *Supra note 19*, para 4.3

³⁰ *Supra note 75*, para 4.3.1

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abolished on 24 May 2017, as announced by Finance Minister Arun Jaitley during the 2017-2018 budget speech in Lok Sabha. Furthermore, the individual departments of government are empowered to clear FDI applications [but this can only be done after consulting with DIPP]. DIPP correspondingly has also been given charge of issuing standard operating procedures for the processing of FDI applications.³¹ Therefore, the above-mentioned recommendation fails to solve the current issue.

VI. ROLE OF SECURITIES AND EXCHANGE BOARD OF INDIA:

The Securities and Exchange Board of India (SEBI) is the regulator for the securities market in India. It was established in 1988 and given statutory powers on 30 January 1992 through the SEBI Act, 1992.³²

Registration as an FII required fulfilment of various conditions prescribed by SEBI likewise the entity has to be regulated by an appropriate regulatory authority overseas; it should have a track record as per regulation provided by SEBI etc. Furthermore, as per SEBI requirements, any sub-account can be registered under an FII only if the FII is the investment manager for such sub-accounts.³³

Indian stocks, like those of other emerging market economies, were in great demand overseas. Some of these investors wanted to register themselves with SEBI, but due to the conditions prescribed for FII registration, they were unable to register themselves as such. Therefore, the practice of FIIs issuing Participatory Notes, Equity Linked Notes, etc. to such overseas investors becomes prevalent in the Indian Securities market. The instruments which were used for issuing participatory notes were termed as Offshore Derivative Instruments (ODIs) as they derive their value from the underlying Indian security. Foreign institutional investors (FIIs) are entities that are established or incorporated outside India, and which intend to make investments in India. Before the SEBI (FPI) regulation of 2014 (discussed later in the article) was introduced, FIIs used to act in consonance with the guidelines

³¹ Office Memorandum F.No.: 01/01/FC12017 –FIPB, MINISTRY OF FINANCE, GOVERNMENT OF INDIA, 5th June ,2017, Available at: <https://fifp.gov.in/Forms/OMabolitionFIPB.pdf>

³² About SEBI, SECURITIES AND EXCHANGE BOARD OF INDIA, Available at : <https://www.sebi.gov.in/about-sebi.html>

³³ See, SEBI (FII) Regulation, 1995, Regulation 12.

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suggested and cased by the SEBI (Foreign Institutional Investors) Guidelines, 1995. With these regulations, FIIs also had to adhere to the notification issued by RBI.³⁴

Because many investors [such as hedge funds] were unable to register as FIIs, much trading was done through derivatives such as participatory notes, also known as P-Notes. Participatory Notes have been used by FIIs since FIIs were permitted to invest in the Securities Market. They were not specifically dealt under the regulations until 2003. According to Regulation 15(A) of the Securities and Exchange Board of India (SEBI) Regulations, 1995 [which was inserted later in 2004 and further amended in 2008 with the objective of tightening regulations in this regard], PNs could be issued only to those entities which were regulated by the relevant regulatory authority in the countries of their incorporation and were subject to compliance of “Know Your Client” norms. Issuance or transfer of the instruments could be made only to a regulated entity. Further, the FIIs who issue PNs against underlying Indian securities are required to report the issued and outstanding PNs to SEBI in a prescribed format.³⁵

However, SEBI observed that these restrictions so imposed were ineffective. Therefore, during October 2008 these restrictions were removed. This was also done to increase the capital inflow in the country.

In 2011, a circular was issued by SEBI stating new conditions for KYC. The circular was silent on the position of Non-resident Indian (NRIs) involved in the transaction for FIIs.³⁶ But according to new disclosure requirement, FII has to disclose that they are not involved in any transactions with NRIs.

This issue and the grey area which was created have been solved under new SEBI (FPI) regulation 2014. Regulation 32 under it's “Obligations and responsibilities of designated depository participants” provides that the DDPs hold due diligence and has to make sure that the applicant for FPI does not hold any other depository account as FPI or as NRI.

³⁴ Regulation 6(1)(c) *Id.*

³⁵ Circular No. FITTC/CUST/14/2001 dated October 31, 2001, SEBI.

³⁶ Circular no. : MIRSD/SE/Cir-21/2011, dated Oct. 5, 2011, SEBI.

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The key changes in the SEBI regulations on foreign investment throughout the years were related to the judgments of some important case laws and events discussed hereafter, which forms the backbone of the current scenario of the foreign investment.

A. UBS SECURITIES ASIA LTD. V. SECURITIES AND EXCHANGE BOARD OF INDIA³⁷:

FACTS OF THE CASE:

There was a sharp fall in Sensex observed by SEBI on 17th May, 2004. This fall in the Indian Stock market leads to a temporary slowdown in the trading on NSE (National Stock Exchange) and BSE (Bombay Stock Exchange). It was first the time in the history of the stock market when such a sharp fall was witnessed in India.³⁸ While investigating into the matter SEBI found out that UBS securities Asia Ltd sold out securities of the amount to the extent of Rs. 188.35 crores. UBS securities were a major participant who's action resulted in this market stagnancy in the Security market. Further, it was investigated that USB sold a large number of securities on behalf of other entities to which Offshore Derivatives Instruments were issued. SEBI issued a notice to UBS and called for all the information regarding its clients which were issued ODIs. The information (address, name of their directors, fund managers, other shareholders) related to its clients (top 5 investors) was called for. UBS was prohibited from further issuance of ODIs by SEBI. An appeal against this order was filed by UBS.

JUDGEMENT:

The SAT ruled against SEBI's order prohibiting UBS from issuing ODIs. The Tribunal ruling was arrived at after considering primarily the following factors: FII regulation 1995 does not provide any clear provisions on the fact that whether there is any obligation on FII to provide information regarding the top five investors or the shareholders of the clients of UBS. As the regulation does not provide clear guidelines regarding such information,

³⁷ CompLJ 28, 2005, SAT.

³⁸ *Market crash of May 17, 2004 SEBI clamps down on UBS Securities*, THE HINDU, BUSINESS LINE, Published on: 18th May, 2005.

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therefore UBS does not hold any of such information. Also, as the clients of the investor could keep changing stream and because of the absence of any regulation regarding continuous monitoring over such change, no information is available with UBS. No such requirements were mentioned under Regulation 15A of the FII regulation of 1995, therefore, there is no violation made by UBS under Regulation 20 which provides for FII to file information regarding records or documents to SEBI or RBI.

**B. GOLDMAN SACHS INVESTMENTS (MAURITIUS) LIMITED V. SECURITIES AND EXCHANGE BOARD
OF INDIA³⁹:**

FACTS OF THE CASE:

SEBI issued a notice to Goldman Sachs Investment (Mauritius) Ltd. which was registered as sub-account under SEBI.

The allegation placed was that Goldman Sachs is liable for issuing “Off shore derivative instruments” to an overseas corporate entity that is “Magnus Capital Corporation Ltd” and that the Goldman Sachs was liable for violation of Regulation of 15A of the FII regulation 1995, which provides conditions to be furnished before issuance of Offshore Derivative Instruments. Goldman Sachs gave SEBI a modified undertaking stating that: “Goldman Sachs Investment (Mauritius) International Ltd., undertake on behalf of itself and its affiliates (Goldman Sachs) that as far as it is aware, Goldman Sachs has not entered into any offshore derivatives on Indian underlying directly with Indian Residents, NRIs or OCB’s (each as defined under relevant Indian laws and regulations) during the statement period.

As agreed with SEBI, this undertaking does not extend to persons of Indian Origin, whether comprising part of the above categories of persons or otherwise.” This undertaking was substantially different from the one required by SEBI and was qualified by the words “as far as it is aware”. Goldman Sachs filed an appeal against the order of SEBI.

³⁹ Appeal No. 153 of 2006, SAT order.

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JUDGEMENT:

SAT set aside the order of SEBI primarily on two grounds:

There were no restrictions on the issuance of FIIs or their sub-accounts against issue or purchase of any derivative instrument to the overseas corporate bodies or Indian residents. Therefore, it was presumed that such transactions have no restrictions over it and in absence of any restrictions Goldman is not bound to furnish any information regarding such transaction to SEBI. It was also alleged by Goldman that the notice issued by SEBI was not clear with the allegations which were placed against Goldman and this results in failure of natural justice for which Goldman Sachs was authorised for.

However, even after the SAT ruled in Goldman Sachs favour, the undertaking required by SEBI was still in place and required to be followed by the FIIs.

AFTERMATH:

The outcome of this judgement was that the new amendment was brought by SEBI in 2007. After 2007, sub-accounts were no longer eligible for issuance of ODIs. Also, ODIs were not allowed to trade on Indian exchange as their underlying assets. The effect of this amendment was such that no FII could issue additional ODIs and they were forced to redeem or cancel. This resulted in the decline of foreign capital in India. Hence, the in year 2008, these restrictions were lifted and the new amendment was introduced. As per the new amendment of the year 2008, ODIs may only be issued to persons who are regulated by an “Appropriate Foreign Regulatory Authority.” This provision still holds a position in the current FPI framework for Category II FPI investor [mentioned later on in this article].

Under the Securities and Exchange Board of India (Issue of Capital and Disclosure Requirements) Regulations, 2009, except for “a sub-account which is a foreign corporate or foreign individual”, a foreign institutional investor and sub-accounts registered with the Board were included under the definition of “qualified institutional buyer”.⁴⁰

⁴⁰ Regulation 2(zd) of Securities and Exchange Board of India (Issue of Capital and Disclosure Requirements) Regulations, 2009.

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C. MATTER OF JERMYN CAPITAL LLC⁴¹:

FACTS OF THE CASE:

Jermyn Capital LLC is a limited liability Dubai based company, incorporated under United Arab Emirates Federal Law. The company was registered as FII under the SEBI FII regulation of 1995. Jermyn Capital holds a corporate sub-account of FII that is Taib bank E.C. On November 30, 2005, Taib bank was directed to stop trading in Indian securities done on behalf of Jermyn Capital. SEBI issued this order after receiving ‘credible information’ about Jermyn capital that it did not meet the standards for ‘Fit and proper person’ for SEBI. Jermyn capital filed an appeal against the order of SEBI.

JUDGEMENT:

The Hon’ble ‘Securities Appellate Tribunal’ (SAT) upheld the order stated by SEBI and declared that Jermyn capital does not qualify to be a ‘fit and proper person.’ SAT observed that the impression of fit and proper person is formed on the basis of company he keeps or on the basis of past conducts of that person. And in case of a corporate entity, the reputation is formed on the basis of its managing partners of whole-time directors. Mr. Doshi who was executive Director of Jermyn capital and his close relationship with Mr. Andrews who was manager and shareholder of Jermyn capital did not hold a good reputation.

Thus, the company was not a fit and proper person under the conditions mentioned in Regulation 13(1) (b) of the SEBI (FII) Regulation 1995.⁴² Against order issued by SAT, another appeal was filed before the Supreme Court. But the Supreme Court also upheld the order of SAT and SEBI. Jermyn capital was restrained from trading in Indian securities and it was also held that the restraint shall continue up to the expiry of 2 years starting from the date from which the association between Jermyn Capital Partner and Mr. Doshi is terminated.

⁴¹ In the matter of Jermyn Capital LLC, (WTM/MSS/ID 5/06/09), dated June 1, 2009.

⁴² See, Regulation 13 - Procedure and grant of registration of sub-accounts, of SEBI (FII) Regulation, 1995.

**D. "MARKET MANIPULATION, MARKET MANIPULATION USING GDR ISSUES AGAINST PAN ASIA
ADVISORS LIMITED (NOW KNOWN AS GLOBAL FINANCE AND CAPITAL LIMITED) AND MR. ARUN
PANCHARIYA"⁴³:**

SEBI suspected manipulative practice taking place when SEBI received an alert regarding "off-market transaction in its integrated Market Surveillance system". After the preliminary investigation, it was revealed that few FIIs were converting GDRs into equity shares. Further, they were selling them in Indian markets. SEBI also observed that the conversions were taking place within a short passage of time just after the GDRs were issued to those companies. On September 21, 2011, SEBI issued direction against Mr. Arun Panchariya and Pan Asia Advisor Ltd. Under the fraudulent scheme executed by Panchariya, the loan was raised for the subscription of GDRs and after subscription of GDRs, it was further sold to FIIs/sub-accounts. And after GDRs were converted into equity shares, the shares were sold in the Indian securities market. A loan agreement was signed with "European American Investment Bank AG (hereinafter referred to as Euram)" by Vintage (controlled by Panchariya) the borrower. The loan was issued by Euram in order to subscribe GDRs. There was no real movement of funds involved in the whole transaction.

As the entries of the loan were made in Book of Euram under the name of Vintage and entries of Issuer Company for the issue of GDRs which was kept as security were also made with Euram, so without the actual inflow of fund the issuer company was issuing a huge number of GDRs. This issue of GDRs in the financial statement maintained by the company was misleading. On the one hand, there was the sight of large inflow in the capital of the company which was visible in the book entries maintained by the company and on the other hand, the GDRs created were purchased without any real transaction of any cost.

It was observed by SEBI that the purpose for which GDRs were issued have been defeated in the following circumstance. The capital which was raised by a foreign investor through GDRs was ultimately paid by Indian investors. Because the underlying security of GDRs, i.e., shares were sold in the Indian market on price which was manipulated by issuer

⁴³ Final order against Pan Asia Advisor Ltd. and Panchariya, (WTM/SR/ISD/06/09/2013), dated June 20,2013.

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company with the help of vintage that was controlled by Panchariya. It was also observed by SEBI that the scheme of two-way fungibility under the scheme of GDRs allows the conversion of GDRs into underlying security and vice-versa. The direct impact of such conversion is bear by the security market of India.⁴⁴

This practice of market manipulation done by Panchariya and Pan Asia Ltd is violative of “*Regulations 3 and 4 of the Securities and Exchange Board of India (Prohibition of Fraudulent and Unfair Trade Practices.*” The regulation prohibits any person from indulging in any activity which leads to defraud in relation to dealing with the issuance of the securities which are listed on the exchange market. These regulations also prohibit any person from employing in course of business engaged in such operation which are or would deceit any person involves in the issuance of securities from the stock exchange.

E. REPORT OF THE COMMITTEE ON 'RATIONALISATION OF INVESTMENT ROUTES AND MONITORING OF FOREIGN PORTFOLIO INVESTMENTS⁴⁵.

SEBI under the chairmanship of Shri K.M. Chandrasekhar formed “Committee on Rationalization of Investment Routes and Monitoring of Foreign Portfolio Investments”. The guidelines mentioned in the committee report were prepared by “Working Group on Foreign Investment in India (WGFI)”. These guidelines were submitted to Government of India (GoI) and the necessary framework was to be created by SEBI/RBI based on the instruction given by GoI. The report of the committee gave directions regarding various portfolio investment routes. The committee was of the view that a single route should be created for FPI, FII, sub-account. Hence, the investment route needed to be harmonized in order to overcome the issue of multiple routes and to simplify the process of investment.⁴⁶ The committee suggested that FPI would not be required to directly register under SEBI. Instead of SEBI, Designated Depository Participants (DDPs) which were authorised by SEBI, can register FPI. DDPs will be subjected to conditions prescribed by SEBI with regards to KYC

⁴⁴ *Id.*

⁴⁵ Shri. K.M. Chandrasekhar, *Report of the Committee On 'Rationalisation of Investment Routes and Monitoring of Foreign Portfolio Investments*, SEBI, June 12, 2013, Available at http://www.sebi.gov.in/cms/sebi_data/attachdocs/1372854491698.pdf

⁴⁶ *Supra note 38 para 1.1*

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norms. DDPs were permitted since they may work in due diligence while allowing entities to make such investment in securities.⁴⁷

In the case of “Know Your Customer” norms a risk-based approach was suggested. On the basis of level risk involved, the groups of investors were divided into different categories:

- **Category I – Low Risk:** where the eligible investors were Government and Government related investors such as central banks, Government agencies. These were categorized as low-risk entities.
- **Category II – Moderate Risk:** This category includes banks, mutual funds, University-related endowments etc. As they are appropriately regulated, therefore considered as moderate risk entities.
- **Category III – High Risk:** This includes charitable trusts, individuals, corporate bodies family offices etc. As they are not appropriately regulated in their home jurisdiction, therefore the high risk is involved.⁴⁸

For filing of identification documents, eligible investors belonging to Category I and II shall be done away with.⁴⁹ In case of issuance of Participatory notes (PNs) or offshore derivatives instruments (ODIs), the committee recommended restriction on Category III investors. Also, investors belonging to Category II which are not regulated by appropriate regulation in their home jurisdiction will not be allowed to issue PNs/ ODIs. Those, who are the issuer of PNs/ODIs, would have to report directly to SEBI on a regular basis.⁵⁰

F. SEBI (FPI) REGULATION 2014:

On January 7th 2014 through notification, SEBI published “the Securities and Exchange Board of India (Foreign Portfolio Investors) Regulations, 2014”.⁵¹ On the basis of Chandrasekhar committee report, these regulations were formed. Under Regulation 5, categories of FPI were divided as per the committee report. Regulation 2 (h) states that “a

⁴⁷ *Supra note 38 para 1.1.2*

⁴⁸ *Id.*

⁴⁹ *Supra note 38 para 1.1.6*

⁵⁰ *Supra note 38 para 1.2.3*

⁵¹ Order No. LAD-NRO/GN/2013-14/36/12, The Securities and Exchange Board of India (Foreign Portfolio Investors) Regulations, 2014, January 7th 2014.

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person who satisfies the eligibility criteria prescribed under regulation 4 and has been registered under Chapter II shall be deemed to be an intermediary in terms of the provision of the SEBI act".⁵² The one comprehensive eligibility criteria for FPI has been provided under Regulation 4 of FPI regulation. Under FII regulation of 1995, there were two sets of criteria for eligibility (one for FII registration and another for sub-accounts). The issue of a certificate under FII regulation was directly in the hand of SEBI, but now this has been delegated to DDPs. DDPs can pursue approval from SEBI under Chapter III. The responsibilities of DDPs have been mentioned in Chapter VI.⁵³

As per the Chandrasekhar committee report recommendations, Category III shall not be allowed to issue PNs/ ODIs.⁵⁴ Also, it can only be issued to Category I and Category II FPI. This has been incorporated under Regulation 22 of FPI regulation, 2014.

G. HARUN R. KHAN COMMITTEE REPORT ON FPI REGULATIONS 2014:

The H.R. Khan Committee submitted its report on FPI Regulations 2014 to SEBI as on 24th May 2019.⁵⁵ The committee suggested some important changes in the FPI 2014 regulations. Some of the important changes as suggested by the committee are listed below:

- i. Fast track on-boarding process for select Category II FPIs
- ii. Simplified registration for Multiple Investment Manager (MIM)structures
- iii. Pension fund to be considered for Category I FPI registration
- iv. Review of broad-based condition for appropriately regulated entities
- v. Deemed broad-based status for insurance/ re-insurance entities
- vi. Entities majorly owned by investors eligible for Category I FPI registration shall be deemed as Category I FPI
- vii. Certain entities owned by Category II eligible investors shall be eligible for Category

⁵² *Id.*

⁵³ B.N. Srikrishna, *Report of the Financial Sector Legislative Reforms Commission*, MINISTRY OF FINANCE GOVERNMENT OF INDIA, 22nd March, 2013.

⁵⁴ K.M. Chandrasekhar, *Report on Rationalisation of Investment Routes and Monitoring of Foreign Portfolio Investments*, SECURITIES AND EXCHANGE BOARD OF INDIA, 12th June, 2013. Available at : https://www.sebi.gov.in/sebi_data/attachdocs/1372854491698.pdf

⁵⁵ Harun R. Khan, *Report of the Working Group on FPI Regulations*, SECURITIES AND EXCHANGE BOARD OF INDIA, 24th May, 2019. Available at: https://www.sebi.gov.in/sebi_data/commdocs/may-2019/Annexure-A_p.pdf

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- II FPI registration
- viii. Simplified registration requirement for Category III FPIs
 - ix. Removal of ‘opaque structure’ definition
 - x. Separate registration for sub-funds of a fund with segregated portfolio
 - xi. KYC Reliance on same group regulated entity of custodian for non-PAN documents
 - xii. Liberalized investment cap
 - xiii. Review of prohibited sector for foreign investment for FPIs
 - xiv. Review of restriction on Sovereign Wealth Funds for investment in corporate debt securities
 - xv. Liberalization for regulated Category III FPIs
 - xvi. Permitting FPIs for off-market transactions
 - xvii. Harmonization between investment restrictions in FPI regulations and FEMA 20(R).
 - xviii. Reclassification of investment from FPI to FDI
 - xix. Alignment between FPI and AIF routes
 - xx. Strengthening of ODI framework
 - xxi. Entities established in the IFSC be deemed to have met the jurisdiction criteria for FPIs

VII. THE FINANCIAL SECTOR LEGISLATIVE REFORMS COMMISSION⁵⁶:

The commission was constituted by the Ministry of finance in March, 2011. The commission was set with the objective of reviewing the institutional and legal structure of the financial sector of India. According to the findings of the Commission, the regulations governing the transaction of the current account and capital account were complex and lacks clarity.

Two main difficulties were addressed by the commission:

- Difficulties of multiplicity due to the presence of multiple laws and multiple regulators: There are several institutional bodies who are regulating the capital flow under the said regulations. Several ministries are involved in the process of approval for FDI through FIBP route. “The Ministry of Commerce and Industry hosts the Department of Industrial Policy and Promotion which is responsible for promulgating

⁵⁶ *Id* at pg. 82

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policy on FDI into the country".⁵⁷ It was also observed by the commission that investment through different Vehicles such as FIIs, "Foreign Venture Capital Investors (FVCIs)" and the "Qualified Foreign Investors (QFIs)" and these were controlled differently as per the policy consideration. Also, the non-residents are treated unequally as compared to the person who is of Indian origin.

- Difficulties of absence: It was observed by the commission that there is an absence of a legal process as the current regulations are "devoid of any public consultation". There is no right provided to the investor for exercising judicial review. SEBI/RBI can cancel the approval for investment on any grounds. Like the in case of Bycell telecom, no proper justification was provided to the petitioner for cancellation of the approval by FIPB. Also, in a matter of Jermyn Capital, SEBI restricted FIIs to trade in Indian securities on the vague ground that the entity does not fulfill the criteria of "fit and proper person" provided under SEBI (FIIs) regulation of 1995.

To solve the issue of multiplicity and in order to bring clarity in the process of capital flows, the Commission proposed to draft a single code which would provide clearer and a fair framework for dealing with capital account transactions.

In the case of the inward flow of capital, the rules will be made by the central government in consultations with RBI. In case of the outward flow of capital, the rule is to be made by RBI with consultations of the central government. The recommendations made by the commission were inserted in the Indian Financial Code under Chapter 60, Section 240.⁵⁸

The code has not been notified and hence the issue addressed by commission still stands in the present time.

⁵⁷ *Supra note 46*, pg 83

⁵⁸ Bill No. abc of 2013, *Indian Financial code*, GOVERNMENT OF INDIA, Section 240 of Chapter 60 'CAPITAL ACCOUNT TRANSACTIONS' of Indian financial code of 2014 states that-

"(1) The Central Government may prescribe, – rules.
(a) the prohibition of one or more classes of capital account transactions;
(b) the requirement to obtain the approval of the Central Government in relation to a capital account transaction that affects national security;
(c) the requirement to obtain the approval of the Central Government or the Reserve Bank to enter into any class or classes of capital account transactions; and
procedures, conditions, limits or restrictions in relation to any class or classes of capital account transactions."

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VIII. SAHOO COMMITTEE REPORT:

The Ministry of Finance vide office order dated September 23, 2013 (Annexure-A), constituted a seven-member committee under the chairmanship of Mr. M.S. Sahoo, Secretary, ICSI, to comprehensively review the Foreign Currency Convertible Bonds and Ordinary Shares (Through Deposit Receipt Mechanism) Scheme, 1993 ('the Scheme').⁵⁹

This is the third report (Report III) prepared by this Committee, the previous two have dealt with the issuance of American Depository Receipt (ADR)/Global Depository Receipt (GDR) (Report I) and the issuance of Indian Depository Receipt (IDR)/Bharat Depository Receipt (BhDR) (Report II).

The recommendations of Report I have been substantially implemented through the new Depository Receipts Scheme, 2014. Also, the union budget for the years 2014-15 has proposed to completely revamp the IDR scheme with an aim to introduce a more ambitious, liberal and progressive BhDR. These reformative measures adopted by the government are a resultant of recommendations of Report II.⁶⁰

All the three reports have consistently formulated strategies and identified problem areas, like impending market failure, and have also laid down proactive measures to counter and recover from such crises. With the addition to that, the removal of all aspects other of capital controls or administrative oversight/overhead has been suggested.

The committee in its report has envisaged an economic climate which yields a substantial reduction in the costs of doing business in India and enhances India's engagement with financial globalization. Thus, the resulting framework carries conceptual clarity, reduces the legal risks involved and minimizes the interaction of private firms with the authorities, thereby increasing the ease of doing business in India.

⁵⁹ M. S. Sahoo, *Report of the Committee to Review the Framework of Access to Domestic and Overseas Capital Markets (Phase II, Part I: Indian Depository Receipts)*, MINISTRY OF FINANCE, GOVERNMENT OF INDIA, 9th June, 2014. Available at: https://www.finmin.nic.in/sites/default/files/idr_report_20140609.pdf

⁶⁰ *Id.* at pg. 98

IX. PRESENT SCENARIO:

Abolition of FIPB has reduced the complexity of multiple regulators. Now, DIPP remains the sole regulator automatic route for FDI.⁶¹

In case of FPI policies, SEBI in its recent circular “*Eligibility conditions for Foreign Portfolio Investors*” stated that beneficial ownership criteria should be made applicable for the purpose of KYC and not for determining the eligibility of FPIs. NRIs/OCIs/Resident Indians (RIs) are not allowed to invest directly in FPIs and only investment managers (IMs) can control FPIs. IMs are owned or controlled by NRI/ OCI/ RI and will only be eligible to invest if they are appropriately registered with SEBI and are appropriately regulated in its home jurisdiction or set up under Indian laws.

The investment should be below 25% from a single NRI/ OCI/ RI and in aggregate should not exceed 50% to the total amount of FPI.⁶²

According to SEBI’s circular on “Know Your Client Requirements for Foreign Portfolio Investors (FPIs)” beneficial ownership would mean “25 per cent ownership in a company or 15 per cent in a trust or partnership depending on how an FPI is structured abroad”. But eligibility of FPIs shall not be determined by beneficial ownership criteria and should be made applicable only for the purpose of KYC. The entry barrier is stiffer as the threshold is 10 per cent if an FPI is from a high-risk jurisdiction and KYC review should also be done on a yearly basis.⁶³

Clubbing of investments in FPIs will also not be determined by beneficial ownership criteria. Common ownership of more than 50% or common control is the driving factor for defining the clubbing of FPIs. 'Common Control' test will apply to club investments made by FPIs.⁶⁴

⁶¹ *Supra Note 25*

⁶² Circular no. CIR/IMD/FPIC/CIR/P/2018/132 dated September 21, 2018

⁶³ Circular no. CIR/IMD/FPIC/CIR/P/2018/131 dated September 21, 2018

⁶⁴ Circular no. SEBI/HO/IMD/FPIC/CIR/P/2018/150 dated December 13, 2018

X. CONCLUSION:

Investment scenario in India has improved considerably since the last decade and the government is also working to provide an efficient, transparent, reliable and predictable environment for the investors. India is the most attractive emerging market for global investors since it is a booming market. But presently, regulatory authorities are still modifying the regulations as per the challenges faced by them discussed through various cases laws and reports in this article.

During the last four years of Indian government led by our Prime Minister Narendra Modi, the Indian economy has gone under many reforms such as Make in India, GST, insolvency framework and tax reforms. In 2019, India's ranking on the World Bank's 'ease of doing business' has improved to 77th position from 142nd position in 2014.⁶⁵

In 2018, FDI in India was at its peak with 235 deals amounting to around 38 billion dollars beating China for the first time in two decades (according to data from Dealogic, a global M&A and capital markets data provider)⁶⁶. Annual FDI inflows in the country are expected to rise to US\$75 billion over the next five years, as per a report by UBS.⁶⁷

⁶⁵ World Bank Group, *Doing Business 2019*, at pg. 5, 16th Edition, 2019

⁶⁶ Sneha Shah, *India pips China in FDI inflows for the first time in 20 years*, THE ECONOMIC TIMES (December 28, 2018), available at <https://economictimes.indiatimes.com/news/economy/indicators/india-pips-china-in-fdi-inflows-for-the-first-time-in-20-years/articleshow/67281263.cms>

⁶⁷ *Foreign Direct Investment*, INDIAN BRAND EQUITY FOUNDATION (March 2019), available at <https://www.ibef.org/economy/foreign-direct-INVESTMENT.aspx>