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# The Legal Framework of Foreign Investment and Protection in India

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***Abstract***

*The act of investment refers to the action of investing money (alternatively referred to as capital) to obtain in return a profit from the act of such investment. Such profit can be in the form of interest, income, appreciation in the value of an asset invested in, etc., depending upon the investor. The current paper explores the concept of foreign investment that has emerged due to the merging of global economies brought about by the age of globalization. The authors have also analyzed the topic of investor protection in relation to the current topic, which has always played an integral role in ensuring that foreign investments flow freely into a market. Different concepts established in the development of cross-border investment have also been discussed in the course of the current paper.*

**Keywords:** Cross-border investment, investor protection, foreign direct investment, Most-favoured-Nation

## INTRODUCTION

"*Don't look for the needle in the haystack. Just buy the haystack!*"
*Quoted by John Bogle when he came up with the idea of an Index Fund*

The golden age of globalization has opened new pathways and revolutionized the way in which investors make economic investments in foreign nations, which in turn has altered the dimensions of the legal structures governing the sphere of foreign investments. Before the age of globalization, States were prone to use trade barriers to block foreign investors due to various reasons, one of the most proclaimed ones being the "protection of domestic industries". However, this period of self-isolation was found to be unsustainable and proved to be fatal to the growth of an economy in the global arena. States had to open their trade borders to foreign investors to develop their respective economies and keep pace with the growing global markets. None of the States had enough resources (natural or otherwise) by themselves to have a sustainable and isolated growth system, and therefore, there arose a need to trade with other nations. Eventually, foreign trade increased exponentially when people realized that foreign investments did not just fulfill the purpose of basic survival of the economy but were also a profiting avenue that could be taken advantage of. Individuals and Organizations realized that there are better opportunities to be availed outside of their economic regions and started making investments in other areas which were profitable and afforded them a degree of protection for their investments in the new and unexplored markets. This led to the rise of international investment or cross-border investment.

International investments are those investments that are made outside the ambit of domestic markets and provide prospects for portfolio diversification and risk reduction. An investor can broaden his potential returns by making foreign investments [1]. In certain circumstances, it aids in reducing certain

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systemic risks associated with the economies of various nations. The eligible instruments for an investment portfolio are typically not limited to local investments when it comes to international investing. For inviting foreign investments in a country, the relevant authorities need to make their economies look lucrative to the investors and assure their protection from *mala fide* entities who seek to take undue advantage of the unfamiliarity of a foreign investor with the domestic market and illegally profit off the investments. Proper legal structures and legislations need to be enacted accurately and without inconsistencies to ensure an airtight system that encourages all types of investors to invest in both the domestic and foreign markets.

In the current review paper, the authors would emphasize analyzing the concept of foreign investment and various types of foreign investments existing in an economy along with the concept of investor protection concerning the provisions in the Indian context, along with a small conclusion detailing the personal view of the authors. The authors have used the qualitative method of research methodology in the present paper intending to analyze the given topic.

The topics are as follows:

1. The Concept of Foreign Investment
2. Protection of Investors

**THE CONCEPT OF FOREIGN INVESTMENT**

Foreign Investment has become a key factor behind the growth and development of a nation and its economy. International investment is used by the nation to increase its working capacity by the way of training manpower, investing in resources, acquiring better and more efficient technology, etc. This increase in production capacity means more potential investments, leading to an increase in the supply and demand by the market forces and thereby expanding the economy. This cycle of frequent investment has become the livelihood of any developed or developing nation which would otherwise be crippled due to a lack of potential foreign investment.

The process of foreign investment in the nation is primarily governed by the Foreign Direct Investment (FDI) Policy of the Government of India and the Foreign Exchange Management Act, a regulatory framework put in place in 1999 that enables the Reserve Bank of India (RBI) to enforce regulations and the Central Government to implement rules regarding foreign exchange in accordance with the Foreign Trade Policy of India [2]. In India, FDI can be done via two methods. The first one is called the Government Route; wherein prior permission must be taken by the investor from the Government of India before investing in sectors that the Government has declared as restrictive. For example, in the sectors of Print Media, Civil Aviation, Satellites, etc., a proper application with the required documents is to be filled out and submitted by the investor before the Government would consider approving the action of foreign investment. The Government restricts investment in such sectors as they have a very pivotal role to play in a nation’s structure, and they can’t afford to allow foreign influences to hold too much of a sway over these sensitive structures. The second method is when no prior approval is required by the investor in the foreign country to invest in the domestic market. It is implicit that the Government and the Reserve Bank of India (RBI) have already given them unreserved permission to participate by investing in the market. A few examples of such sectors which are part of the Automatic Route are Manufacturing, Agriculture and Farming, Automobiles, Biotechnology, etc.

However, just establishing the proper structures is not enough for FDI to flow into the Indian economy, the government also needs to frequently make active changes to their FDI policies and other investment laws to attract foreign investment. Better Ease of Doing Business (EoDB) and proper Investor Protection Laws, along with plenty of opportunities, always ensure a plethora of foreign investors willing to invest in a developing economy, and that has been the aim of the Indian Government. In its objective of increasing India’s Ease of Doing Business Index, the Government has amended and expanded the list of industries that fall under the ambit of the Automatic Route, where no prior approval from either the Government or the RBI is required. Next, to incentivize foreign investors, the government has increased the previous slab of 51% FDI to a level of 74%, and even 100% in certain industries, like agriculture, petroleum & natural gas, construction development, etc., to attract more investments [3].

To make the economy look even more lucrative, the Government has also altered various tax rates and is offering concessions to potential investors. The Government has reduced the long-term capital gain tax rate for foreign corporations to 20% and has also exempted export earnings from the head of corporate income tax for both domestic and foreign organizations. Additionally, the Government has cut the corporate tax rate imposed on foreign organizations from 65% to 55%. Thereafter, to also support domestic organizations, the government has changed the regulations to ensure that now Indian organizations do not need the prior approval of the RBI for the issue of shares to foreign investors or for the internal settlement of foreign exchange. However, this does not mean that the Indian Government has completely opened its gate to foreign investment and influence, which became evident when the Government reviewed its FDI policy in 2019 to make foreign investment more stringent to stop opportunistic takeovers of Indian organizations by foreign elements.

Now, let us discuss the various types of Foreign Investment allowed under Indian regulations. Currently, there are three different methods of potential investments available to foreign investors, namely:

**Foreign Direct Investment**

FDI occurs when a foreign organization acquires a majority stake in a business entity in the domestic economy. Foreign enterprises are directly involved in the day-to-day operations of the domestic organization in the country receiving FDI. Generally, it occurs when a foreign investor creates or acquires domestic businesses or assets, including acquiring ownership or a controlling stake in the firm. One of the major benefits of an FDI is that the foreign investors bring not only money to the table but also various knowledge, skills, and technology that may be better than those already existing in the domestic market. The knowledge, skills, and technology then filter downstream the economy to various other structures, benefitting not only the sector receiving the FDI but also bolstering the economy in the process. Nevertheless, the Government also strictly monitors and controls FDI in certain sectors due to the nature of certain industries. For example, no FDI is allowed in the sectors of Betting, Gambling, Atomic Energy, Nidhi Companies, etc. [4].

As discussed before, the government is continuously amending its FDI policies and laws to keep abreast of the existing circumstances. Recently, the government declared that any non-resident entity from Pakistan, Nepal, Bhutan, China, Afghanistan, or Myanmar can only invest in India with governmental consent [5]. Additionally, governmental consent is also required if the beneficial owner of an investment made in India resides in or is a citizen of the country. Such limits are applied in case a direct or indirect transfer of ownership of any potential or current organization of the domestic economy falls in the hands of doubtful individuals from the restricted nations. Any investment made prior to the implementation of the new policy changes is grandfathered, i.e., the old rule continues to apply to existing investments while the new rule would apply to all future investments from the date of the implementation of the policy changes.

**Foreign Portfolio Investment**

Foreign portfolio investment (FPI) refers to the investment made by foreign entities and non-residents in Indian securities, such as shares, bonds, government securities, convertible securities, and other financial assets. The objective of an FPI is to secure a controlling stake in a company in the domestic market at a lower level of speculation or investment than that required in an identical investment done under FDI, or conversely to just generate short-term financial gains, depending on the investor's goals.

 

The principal legislation that regulates and governs acquisitions and investments by foreign nationals is the Foreign Exchange Management Act (FEMA), along with rules and regulations thereunder, the Rules 2019 and Regulations 2019, as well as other notifications, circulars, and directions pertaining to foreign investments issued from time to time by the Central Government and RBI [6]. In addition to following all domestic established foreign exchange laws, rules, policies, and regulations, all foreign investors must also follow sector-specific and state-specific laws that apply to their relevant industries.

The government also changed its FPI policies during the Covid Pandemic, wherein the Securities Exchange Board of India (SEBI) implemented measures to protect foreign investors and minimize the strain on business operations by enacting a modification of the FPI license renewal criteria to initiate FPI investment yet again in India following the lockdown period. Simplification of the registration process and liberalization of the eligibility criteria were also emphasized by the government during the policy changes, while also curbing opportunistic takeovers by foreign investors [7].

**Foreign Institutional Investment**

Foreign Institutional Investment (FII) refers to an investor or investment fund that invests in a country other than the one where it is based or registered. For organizations to invest in line with the FII concept, they need to sign up on the stock exchange of the host country. Mutual funds, hedge funds, pension funds, insurance or reinsurance companies, and investment trusts that want to invest in India are all part of the portfolio of FII investment. FIIs are a big source of capital for developing countries, but many of them, like India, have established certain restrictions on how much total amount an FII can invest in the host country and how many equities shares it can buy, especially in a single company. This helps restrict the effect of FIIs on individual enterprises and the nation's financial systems, as well as the potential damage caused in case of a mass exodus of FIIs during a financial crisis. The maximum investment allowed under FII is 24% of the paid-up capital of an Indian entity [8].

## PROTECTION OF INVESTORS

International Investments as compared to domestic investments are subjected to greater risks and uncertainties. International investment law has established worldwide minimum treatment standards for foreign investors. The major objective of the enactment of international investment law was to safeguard international investors in host nations.

The principle relating to remuneration for expropriation of foreign assets or capital, as well as the resolution of conflicts or reconciling of this kind of matter through international courts and tribunals, have indeed been incorporated into the foreign minimum standard threshold, despite the fact that its subject matter is hard to identify. The minimal standard was recognized as a reasonable justice or civilized benchmark for foreign investors. The minimum international standard incorporates:

**Fair and Equitable Treatment**

The fundamental components of Fair and Equitable Treatment (FET) are fairness and equality, which provides international investors with a main level of safeguarding against their investment in host nations. Due to the challenges in recognizing the interpretations of the phrase 'FET' and its alternate meanings, a significant amount of debate surrounding this criterion has occurred, which either broadens the fair and equal treatment over and above standard international law or, alternatively, prevents the treatment to international human rights law. The analysis of Article 1105 of the NAFTA [9] Commission supports the latter viewpoint mentioning the minimum standard of treatment. Similarly, Central America Free Trade Agreement (CAFTA) [10] includes a standard of FET in accordance with CIL under the international investment treaty.

Nations are obligated to give fair and equal treatment, although this is not a legal obligation. Nonetheless, the nations must provide fair and equal treatment to those nations who include this care with other norms and standards, such as the Most-Favoured-Nation (MFN) and NT. In international law, fair and equal treatment encompasses all factors, including nation’s practice and judicial decisions.

 

It must not only conform to international customary law but also take into consideration the concepts of several treaty obligations. According to the OECD [11], fair and equitable treatment was presented here as a major legal requirement relating to the broad international law principles and it also offers a general framework for the implementation of agreements for settling disputes between nations.

The FET Clause in Bilateral treaties attempts to limit the host nation's authority to abuse, threat, harass, and intimidate foreign investors. It also aims to eliminate arbitrary, unfair, and unjust conditions caused by individual discretionary, biased, or discriminatory actions. Any conduct that violates the legal system which is arbitrary regardless of whether or not it is unlawful under the realms of domestic law. The sole criterion it imposes on foreign investors is to exhaust all lower court's remedies first. It attempts to eliminate discrimination by treating all domestic and foreign investors equally. Non-compliance to exercise due care in the safeguarding of foreign investors alongside their investment. It mandates that the court proceedings should adhere to the principle of due process of law which should not be violated by any court while reaching a judgment that might seem arbitrary or in support of a certain party.

**Full Protection and Security of Foreign Investors**

Foreign Investors are entitled to 'complete protection and security' under the obligation of the various international treaties (including Bilateral treaties or Free Trade Agreements) on treatment standards which obligates the host state to not harm foreign investors or their investments by the states act and should protect the investors against the acts of any individual. The extent of this treatment includes physical protection and security of the investments which more recently has been neglected by the nations to include in their international treaty; It also includes due diligence obligation on host states to exercise reasonable care to protect and prevent harm to investors' investment. The United States has built one of the most solid pillars of Customary International Law, which is this norm. It is the host country's obligation if it fails to protect foreign investors whose investments are endangered or drawn by political wars or physical abuse.

**Safeguard Against Expropriation and Compensating Norm Under International Law**

The principle of international investment law, Security of International Investment from expropriation stipulates a number of mechanisms for seizing the assets of international investors. Thus, if host nations are unable to comply with such regulations, international investors and their assets can be safeguarded, allowing them to oppose such expropriation. The expropriation of overseas investment will be allowed if it: serves the interest of public benefit; is free from discrimination; complies with legal requirements & due process of law; and is followed by financial compensation to foreign investors.

LF Neer v. United Mexican States [12] was the first case to apply the minimum treatment standard to the problem of immigrants' personal security. In the settlement of a claim, states get recompense, not affected citizens. Due to the fact that the lawsuit has an involved nation. states have the power to settle, discharge, or reject the suit. Moreover, in the case of Mondev International Ltd. v. United States of America [13], the court outlined the criteria for determining whether such conduct of the court complies with the terms of the treaty requirements. The court dismissed the Mondev’s claim on the grounds that it did not involve a breach of Article 1105(1) of NAFTA. The convention involves both basic and specific treatment norms, the latter relating to financial payments and expropriation. The basic treatment criteria comprise two types:

***Absolute Standards***

Principles such as FET or FSP to foreign investors, establish the minimum standard of care that contracting parties should maintain such standards.

***Relative Standards***

The Principle of FET provides safeguarding of foreign investments against expropriation for uncertainties of dynamic nature, as this norm sets limitations upon the acts of the host nation.

 

**Statutes Governing Expropriation**

Expropriation is the host state's right to the seizure of privately owned property, irrespective of whether it is towards public interests or other motives. Prominent instances of expropriation include both internal and external tax take of assets, although expropriation is typically the result of indirect legislation measures which have the same effect as a legal seizure of assets. In Goetz v. Burundi [14], the court ruled that the expropriation shall conform to the legal framework of the host nation. The ruling was consistent with the provision clause of the BIT. In the 18th and 19th centuries, international law protecting non-native nations against the seizure of their assets began to be codified into treaties. In the interval, judicial pronouncements, particularly as a consequence of the Second World War paved the way for a global norm on this subject.

This included the improved performance of minimum requirements for the lawful expropriation of foreign assets, such as that the confiscation must take place in the interest of public purpose; with due process of law; linked with non-discrimination; and accompanied by effective and sufficient compensation to foreign investors. Today, the worldwide legal framework for regulating the power to seize foreign assets is mostly included in international investment agreements (IIAs).

IIAs unify the foundational principles for lawful expropriation derived from Customary International Law, but also provide general assistance on the types of assets insured, the requirements for such coverage, and the acts out of which the asset is insured. The distinction between compensable backhanded expropriation and actual, quasi-administrative measures is one of the most important issues considered by foreign tribunals interpreting IIAs. Furthermore, arbitration bodies have yet to accept norms for evaluating compensation and standards for valuing the seized property. Currently, direct expropriation is infrequent and not problematic, however indirect expropriation raises a few challenges.

**Direct Expropriation**

Direct expropriation entails the takeover or legal transfer of a foreign asset, where the asset in question can be proprietary information and commercial property. In cases of direct expropriation, the state has a purposeful intention to deprive the investor of their asset by explicit seizure. Presently, Protection-related investment treaties incorporate language indicating market price as the compensation amount of the seized property.

**Indirect Expropriation**

Indirect expropriation occurs when the host country requires its legislative or administrative powers to draw advantages from foreign investors and seize their assets without altering the investor's contractual relationship with the asset. An illustration of indirect expropriation may be the imposition of higher levies and taxes which eliminate any potential returns from an investment, hence eliminating the incentive for foreign investment. Typically, the host country would not accept that the indirect expropriation is happening, although if an investment company makes a claim to the host country through arbitral proceedings and it is determined that indirect expropriation is happening, then the investor will be entitled to sufficient and suitable compensation for their expenditures on investment. While deciding if host state conduct involves indirect expropriation, judges often concentrate more on the claimed act's impact on the asset rather than on the host nation's purpose or the act.

**Most-Favoured-Nation Treatment**

Most-Favoured-Nation Treatment (MFN) despite its significance in international investment law and international trade regulations. Consequently, the scope of MFN relies on the terms of the treaty. It mandates that state parties to an investment treaty should not be treated with less favorable treatment than other states. The rationale for including the MFN principle in the safeguarding of international investment in Customary International Law is that this policy prevents prejudice against international investors and provides international investments from various nations with similar competitive opportunities. A conventional formulation of the concept of MFN is the minimum level of prejudice and the greatest number of privileges granted to any nation who is contracting party to an international treaty".

MFN treatment in international investment is founded on the concept of fairness, which is described as a host nation treating foreign investors from one different nation equally to investors from some other foreign nation. However, there is a generally accepted explanation of MFN treatment that is assessed in each situation, which states that if a treaty explicitly applies an alternative procedure for resolving conflict, then the MFN clause should be used for conflict resolution. But if any contracting party to a treaty applies for dispute settlement, the tribunal may reject such application under the MFN clause due to the absence of express wording and lack of interpretation under such an international investment treaty.

**Capital Market Regulator (FPI)**

In India, SEBI is the regulator of the financial market which falls under the Finance Ministry of the Indian government. The fundamental function of SEBI is to distribute resources and give facilities to both foreign and domestic investors. SEBI has the authority to develop regulations and guidelines for the protection of shareholder rights (Foreign Portfolio Investment).

SEBI has the authority to oversee the stock markets in the financial market, insider trading, banker functions, stockbroker registration, unit trust, securities-related unfair practices, and the acquisitions of businesses and securities. The SEBI Act and the Companies Act provide combined criminal and civil punishments for the offenses mentioned above:

- Section 15G of the SEBI Act is punishable by a fine of 25 crores or three times the benefit made, whichever is greater. if a whistle-blower has acted with the intention to provide unreleased information or price-sensitive information or has convinced another person to trade stocks of another.
- Section 24 of the Act stipulates that if the Punitive Awards are not satisfied or are in breach of the rules, the offender is subject to 10 years in jail, a fine that can reach rupees 25 crores or both.
- Section 195 of the 2013 Companies Act stipulates a penalty of five years in jail, a fine of 5 Lakhs that may reach 25 crores or three times the profit gained via insider trading, whichever is greater, or even both.

The Satyam Scandal [15] is a well-known case of market manipulation, unethical business practices, and awards for which was ruled by the court was Rs. 1,850 crores fine and criminal charges against the board of the company.

**CONCLUSION**

After globalization, the government has adopted new legislation to improve the legal framework for providing better opportunities to foreign investors. Since 1991, there have been several efforts by the administrates of the Indian economy to adopt measures to attract foreign investors. The government in their present policy has streamlined the procedures and methods in a way that has boosted international investment to increase their economic growth. The government has moved away from restrictions on various industries through liberalization. The protection of investors under international treaties has been defined and interpreted according to their BIT which expressly defines wording and interpretations of protection provided to foreign investors or by the standards of international law. For instance, if an international treaty includes explicit words linked to the minimum standard of protection for foreign investors, then it must apply such standards for assisting international investors. The arbitral tribunals for international dispute settlement have interpreted the standard of treatment to be identified under two major aspects known to be due diligence and due process of law to be considered as the most basic elements for interpreting the standard of treatment to be fair and equal for all investors. These elements have been judged in accordance with international law to provide an accurate interpretation of the standard of treatment for the protection of foreign investors.

 

**Abbreviations**

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| FDI | Foreign Direct Investment |
| FEMA | Foreign Exchange Management Act |
| SEBI | Securities Exchange Board of India |
| FPI | Foreign Portfolio Investment |
| FII | Foreign Institutional Investment |
| FET | Fair and Equitable Treatment |
| NAFTA | North American Free Trade Agreement |
| CAFTA | Central America Free Trade Agreement |
| OECD | Organization for Economic Cooperation and development |
| CIL | Customary International Law |
| FPS | Full Protection and Security |
| MFN | Most-Favoured-Nation |
| IIA | International Investment Agreements |

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