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WHITE BLACK LEGAL is an open access, peer-reviewed and refereed journal provide dedicated to express views on topical legal issues, thereby generating a cross current of ideas on emerging matters. This platform shall also ignite the initiative and desire of young law students to contribute in the field of law. The erudite response of legal luminaries shall be solicited to enable readers to explore challenges that lie before law makers, lawyers and the society at large, in the event of the ever changing social, economic and technological scenario.

With this thought, we hereby present to you

DIRECT PLAY FOR FOREIGN RETAIL INVESTORS IN INDIA: A REGULATORY BREAKTHROUGH OR RISKY PROPOSITION?

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ABSTRACT

This article critically analyses the progressing discussion on allowing foreign retail investors to directly access Indian securities markets, an idea currently under deliberation by the Securities and Exchange Board of India (SEBI). The Foreign Portfolio Investor (FPI) system now controls foreign participation, mostly through Category II enterprises or indirectly through Offshore Derivative Instruments (ODIs) and Participatory Notes (P-Notes). Although regulatory control is ensured by these ways, they also erect obstacles that discourage smaller individual investors from participating in Indian markets. In addition to increasing liquidity and diversifying the investor base, the proposed shift to direct access aims to strengthen India's integration with global financial markets.

The study focused on the possible benefits of such a legislative innovation, including improved price discovery, deeper markets, more foreign exchange inflows, and improved corporate governance. By reducing entry barriers and streamlining compliance, direct access might increase India's appeal to foreign investors while also aligning its policies with global norms seen in nations like the US, EU, Brazil, and South Korea.

Nonetheless, the report also highlights the grave risks associated with further access expansion. Cross-border capital volatility, commonly known as "hot money," can make financial instability worse, particularly if it causes sudden withdrawals that could cause inflationary pressures, currency devaluation, and systemic market instability. Other concerns include money laundering, regulatory arbitrage, and the potential decline in market equity due to disparities in resources and understanding between foreign investors and domestic retail participants.

Keywords: Foreign retail investors, Direct market access, foreign portfolio investor, Capital market liberalization, financial stability risks.

Introduction

Foreign investors may access India's primary and secondary markets exclusively through the Foreign Portfolio Investor (FPI)¹ framework. As per SEBI (FPI) Regulations, a "foreign portfolio investor"² A Foreign Portfolio Investor (FPI) is a person, institution, or entity that is registered with the Securities and Exchange Board of India (SEBI) to make investments in Indian securities such as listed shares, government securities, corporate bonds, mutual funds, and derivatives.

A foreign retail investor generally refers to an individual investor who resides outside the country and invests in that country's securities market (such as equities, bonds, mutual funds, etc.) for personal investment purposes, rather than on behalf of an institution.

Currently, Category II FPIs allow foreign retail investors to participate in listed Indian securities. Regulation 5³ states that Category II includes entities that do not qualify under Category I, such as suitably regulated funds, endowments, foundations, charitable institutions, corporate entities, family offices, individuals, regulated entities investing on behalf of clients, and unregulated investment vehicles structured as limited partnerships or trusts. In addition, through indirect channels like Offshore Derivative Instruments (ODIs) or Participatory Notes (P-Notes), foreign investors can purchase Indian listed stocks. P-Notes are issued abroad by authorized foreign brokers and are backed by the securities they hold in India⁴.

Moreover, Regulation 3⁵ prescribes that no entity shall engage in the purchase, sale, or dealing of securities as a foreign portfolio investor without procuring a certificate of registration issued by a designated depository participant on behalf of SEBI.

In the fiscal year 2024–25, foreign portfolio investors (FPIs) recorded cumulative net outflows

¹ SEBI(Foreign Portfolio Investors) regulation, 2019

² SEBI (Foreign Portfolio Investors) Regulations, 2019, Regulation 2(1)(j)

³ SEBI(Foreign Portfolio Investors) regulation, 2019

⁴ ET Bureau, Himadri Buch, "India cautious on direct play for foreign retail investors", ECOM Times, April 22, 2025

⁵ SEBI(Foreign Portfolio Investors) regulation, 2019

amounting to approximately US\$14.6 billion, representing nearly 0.3% of India's GDP⁶, underscoring the volatility of cross-border capital movements amid evolving global macroeconomic conditions. Notwithstanding the broader trend of capital flight, the month of May 2025 witnessed a remarkable rebound, with FPI inflows reaching a record ₹19,860 crore⁷, as per data of the National Securities Depository Ltd. (NSDL). This exceptional surge occurred despite aggregate net outflows of ₹92,491 crore between January and May, indicating a potential inflection point in foreign investor sentiment⁸. The resurgence in capital flows can be attributed to a confluence of supportive domestic factors—such as resilient corporate earnings, policy continuity, and robust economic fundamentals—alongside a softening US dollar, which collectively enhanced India's relative investment appeal in the emerging market landscape⁹.

SEBI's recent consideration of permitting foreign individuals to participate directly in domestic stocks is a strategic initiative aimed at deepening capital markets, augmenting liquidity, and further integrating India with global financial institutions.

Globally, several jurisdictions offer instructive parallels to India's proposed regulatory shift. The United States¹⁰ and European Union¹¹ permit foreign individual investors to access capital markets through regulated intermediaries, emphasizing transparency and investor protection. Emerging economies like Brazil and South Korea allow direct retail access, subject to registration and compliance with local regulatory frameworks. China adopts a more controlled model, enabling indirect participation through programs like the Stock Connect, thereby balancing openness with capital controls.

This research article critically examines whether the proposed regulatory measure signifies a transformative advancement promoting sustainable economic growth, or whether it exacerbates vulnerabilities to financial instability and systemic risks. By analysing the policy framework and comparative international practices, this study aims to provide a comprehensive evaluation of SEBI's recent contemplation of allowing foreign individuals to invest directly in Indian stocks.

⁶ NSDL FPI Monitor

⁷ NSDL FPI Monitor

⁸ National Securities Depository Ltd., FPI Statistics – Monthly Net Investment Report (May 2025)

⁹ “May sees record Rs 19,860 crore FPI inflow, highest in 2025,” Times of India, (May 31, 2025) (citing NSDL data)

¹⁰ CFIUS Laws and Guidance, U.S. Department of the treasury, 31 C.F.R. Part 800

¹¹ MiFID II (Directive 2014/65/EU) and MiFIR (Regulation (EU) No 600/2014)

It further examines the ramifications with regard to market stability, investor protection, and enduring economic resilience. The purpose of this paper is to add to the larger discussion on financial liberalization in India, specifically with regard to the strategic management of cross-border capital flows and SEBI's consideration of permitting foreigners to make direct investments in Indian stocks.

The Regulatory Breakthrough

A proposal to allow foreigners to invest directly in Indian stocks—currently only possible through the FPI route—is being considered by SEBI¹². The move is intended to expand the investor base, but it faces challenges such as stringent KYC requirements and concerns over potential money laundering. While direct participation by foreign retail investors is a common practice in most major markets, Indian regulators are approaching the idea with measured caution¹³.

Foreigners can now only invest in India's primary and secondary markets using the FPI mechanism. Through Category II FPIs¹⁴, which comprise regulated organizations such as mutual funds, banks, asset managers, investment trusts, and insurance firms, among others, they can invest in listed Indian securities. SEBI has filed Category II FPIs. According to the regulatory framework¹⁵, category I FPIs—an additional bucket—are organizations with lower risk profiles and a higher degree of regulatory monitoring, including sovereign wealth funds, pension funds, and government-affiliated businesses. The regulator can better enforce SEBI's rules by limiting flows through regulated investment vehicles.

FPIs are held accountable for compliance when issuing ODIs and P-Notes, but this alternative has lost favour because of worries about a lack of transparency¹⁶.

Like other non-resident investors, agencies may only let non-resident persons from Financial Action Task Force member nations to invest; this group may even be restricted to nations with

¹² SEBI(Foreign Portfolio Investors) regulation, 2019

¹³ Himadri Buch, ET Bureau, "India cautious on direct play for foreign retail investors", ECOM Times, April 22, 2025

¹⁴ Securities and Exchange Board of India (Foreign Portfolio Investors) Regulations, 2019, Regulation 5(b)

¹⁵ SEBI(Foreign Portfolio Investors) regulation, 2019

¹⁶ Himadri Buch, ET Bureau, "India cautious on direct play for foreign retail investors", ECOM Times, April 22, 2025

which India has a bilateral cooperation relationship¹⁷.

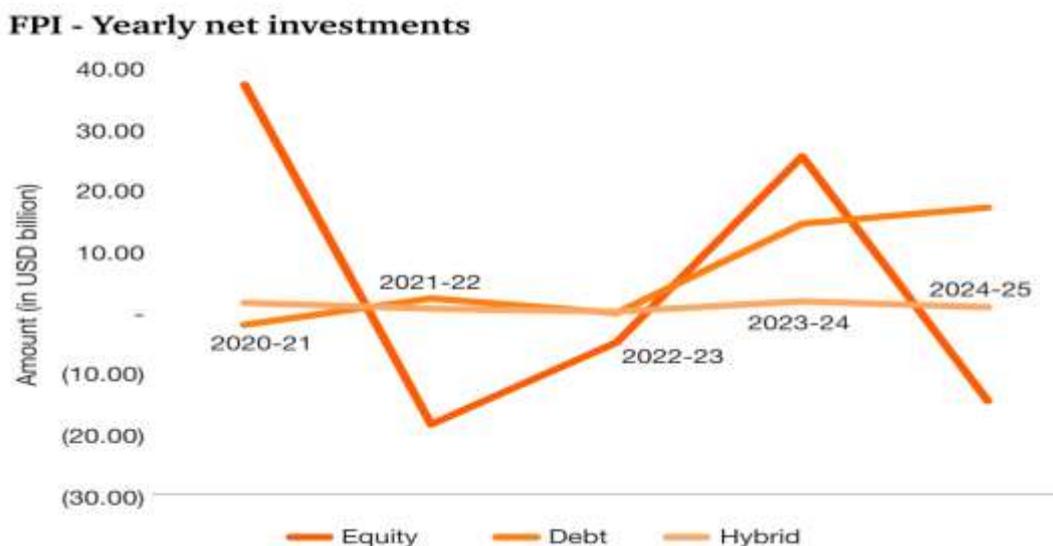
The Reserve Bank of India (RBI) and the finance ministry must ratify the proposal, which is still in the designing stages. The discussions are still at an early stage, with a focus on the need for deeper engagement to determine how the required KYC will be carried out and how related concerns will be addressed.

This move aims to diversify capital inflows, improve liquidity, and position India as a more accessible and alluring investment destination while upholding the necessary safeguards through sectoral caps, surveillance mechanisms, and compliance checks. It is in line with SEBI and RBI's larger agenda of market deepening and global integration.

Prospective Benefits

The impact of FPI in Indian economy becomes clearer when examined through data rather than abstract description. The following figure presents a visual representation of key indicators:

Trends in FPI¹⁸:



SEBI's contemplation of granting direct access to Foreign Portfolio Investors in the Indian

¹⁷ Himadri Buch, ET Bureau, "India cautious on direct play for foreign retail investors", ECOM Times, April 22, 2025

¹⁸ NSDL FPI Monitor

stock market presents several potential benefits, such as the expansion of the investor pool. Higher inflows of foreign currency would build up India's forex reserves and help ease current account deficit pressures. Direct access would also encourage greater retail-level foreign participation, thereby enhancing market depth, improving price discovery, and reducing volatility. According to Kim and Singal, FPIs expand risk-sharing, boost liquidity, and draw in more capital investments—all of which are in line with other research¹⁹.

Increased demand for listed securities intensifies market liquidity, which often translates into improved price discovery and higher valuations for Indian companies. Higher valuations, in turn, lower the cost of raising capital, thereby facilitating greater corporate investment and long-term growth. Allowing direct access for foreign investors to the Indian stock market further enables portfolio diversification beyond their domestic economies, mitigating exposure to risks arising from market volatility, currency depreciation, or political instability in their home jurisdictions. Consequently, such idea not only benefits international investors through risk dispersion but also contributes to the deepening, efficiency, and stability of India's capital markets.

Broader global participation creates pressure for higher transparency, better corporate governance, and improved investor protection which can lead to intersection of Indian practices with international standards. Investors can easily track the performance of their investments and sell their shares at any time. This level of transparency and liquidity can be appealing to investors who prefer to have a clear understanding of their investments.²⁰

Direct investment in the stock market provides investors with the opportunity for long-term capital appreciation. This is because stocks tend to appreciate in value over time, which can lead to significant returns on investment.²¹

According to a study in 2021 research, people's investment decisions are more influenced by

¹⁹ Prof. Harsh Purohit and Rakshanda Dhanda, "Dilemma faced by retail investors while investing in stock market—choosing between direct investment and indirect investment", ISSN: 0974-0066 vol-84 no. 13, July – December: 2023

²⁰ Prof. Harsh Purohit and Rakshanda Dhanda, "Dilemma faced by retail investors while investing in stock market—choosing between direct investment and indirect investment", ISSN: 0974-0066 vol-84 no. 13, July – December: 2023

²¹ Prof. Harsh Purohit and Rakshanda Dhanda, "Dilemma faced by retail investors while investing in stock market—choosing between direct investment and indirect investment", ISSN: 0974-0066 vol-84 no. 13, July – December: 2023

their sense of comfort or principle than by statistical analysis. Psychological biases play a major role in their investment decisions, and they often draw on their own experiences to overcome difficult circumstances. The state's economic and demographic features, according to investors, promote wiser investment choices.²² Granting direct access to the Indian stock exchanges for FPIs would provide greater comfort to foreign investors by reducing compliance requirements. Instead of navigating complex registration processes, individual investors would simply need to open a Demat account to participate in the market. This streamlined approach is likely to encourage a larger number of foreign investors to engage with the Indian capital markets.

Direct access to FPIs has the potential to improve overall financial stability, draw in steady foreign inflows, and expand India's capital markets. Such a reform might make India a more competitive and attractive investment destination by bringing it into line with international best practices.

Risks and Challenges

Despite the widespread perception that foreign portfolio flows boost recipient nation's economies, policymakers around the world are always uneasy about these investments. Such portfolio flows are widely termed as "hot money", given its notorious volatility compared to other forms of capital flows as foreign investors make sudden and coordinated portfolio investment withdrawals at the first hint of problems in the host nation, which speeds up and intensifies the subtle issue of stock price declines and frequently has catastrophic effects on the host economy.²³

Sudden withdrawals of FPI funds can cause rupee depreciation, while currency volatility may worsen import costs, inflation, and external debt servicing. Also, High-speed global investors may gain an unfair advantage over retail Indian investors in terms of information, resources, and trading access, which could ultimately erode confidence in the fairness of the market.

According to attorneys and advisers, enabling direct investments by private investors could increase the number of Indian stock owners, but only if sufficient safeguards have been put in

²² Prof. Harsh Purohit and Rakshanda Dhanda, "Dilemma faced by retail investors while investing in stock market-choosing between direct investment and indirect investment", ISSN: 0974-0066 vol-84 no. 13, July – December: 2023

²³ Suddhasanta De & Tanupa Chakraborty, "Foreign Portfolio Investment and Stock Market Volatility in India", 9 Indian J. Fin. 1 (2015)

place. The domestic brokers who are registered with the Sebi must bear the responsibility for the KYC requirements. With the required reporting system, the custodians may monitor the source of funds and KYC connected to repatriation. Appropriate investment caps can be implemented to prevent route concentration and abuse. Indian authorities have been hesitant due to the possible hazards of money laundering issues in performing fully Know Your Customer (KYC) checks and a lack of tight supervision over international individual investors.²⁴ Due to the possible dangers of money laundering, difficulties performing comprehensive Know Your Customer (KYC) checks, and lax oversight of international private investors, Indian authorities have maintained their prudence.²⁵

Global Comparisons

The pattern of FPI in developed and developing economies are different because of dissimilar economic and political structures.²⁶

Foreigners are permitted to invest directly in the stock markets in large markets such as the US, Europe, China, Hong Kong, Singapore, etc.²⁷. Through a local broker, international retail involvement is permitted in the majority of overseas markets. Under the RBI's liberalized remittance policy, resident Indians are permitted to invest up to \$250,000 annually in equity shares of listed companies abroad. Direct investments in the US stock market are now made possible by a number of domestic brokerages and independent platforms²⁸.

In China, licensed foreign investors can directly invest in mainland A-shares, bonds, and funds. China increased market accessibility in 2019 by lifting the QFII/RQFII quota limits²⁹.

In Iran, the Tehran Stock Exchange (TSE) allows foreign investors to directly invest in equities and bonds listed on the exchange. Initially, there was a 10% cap per company, which was later

²⁴ Himadri Buch, ET Bureau, "India cautious on direct play for foreign retail investors", ECOM Times, April 22, 2025

²⁵ Himadri Buch, ET Bureau, "India cautious on direct play for foreign retail investors", ECOM Times, April 22, 2025

²⁶ Monica Singhania and Neha Saini, "Determinants of FPI in Developed and Developing Countries", Volume 19, Issue 1, September 28, 2017

²⁷ Himadri Buch, ET Bureau, "India cautious on direct play for foreign retail investors", ECOM Times, April 22, 2025

²⁸ Himadri Buch, ET Bureau, "India cautious on direct play for foreign retail investors", ECOM Times, April 22, 2025

²⁹ Foreign Investment Law of the People's Republic of China

raised to 20%³⁰.

Similar to China and Iran, other countries such as the USA, European nations, and Singapore allow foreign individuals to invest directly in their stock markets. However, they have imposed certain restrictions—for example, in China, investment in negative sectors³¹ is not permitted. In India, the proposal to allow Foreign Portfolio Investors (FPIs) or foreign retail investors to invest directly in Indian markets is still under consideration. The Reserve Bank of India (RBI) and the government have not yet given their approval.

CONCLUSION

In conclusion, while several markets allow direct foreign portfolio investment in their stock markets, India has been more cautious due to issues such as regulatory concerns, KYC compliance, and the risk of money laundering. The RBI and SEBI will play a critical role in determining whether greater foreign investment is permitted, given its importance to the Indian economy. India can implement direct foreign portfolio investment as it offers significant potential benefits, but before doing so, it must develop a robust regulatory framework and technological infrastructure to ensure transparency and prevent future mishaps.

³⁰ The Law Governing the Securities Market in the Islamic Republic of Iran ratified by the Islamic Consultative Assembly on 22 November, 2005

³¹ FDI China