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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

# **EXPLORING THE CHANNELS OF CAPITAL INFLOW: ANALYZING DIFFERENT INSTRUMENTS OF FOREIGN INVESTMENTS IN INDIA**

AUTHORED BY - ANEESA NAZAR

## **Abstract**

Foreign investment is an inevitable stimulus for developing countries like India striving towards globalization. Since the economic liberalization of 1990 the Government of India has adopted many economic reforms to catalyze capital inflow into the nation. We have adopted a diverse range of foreign investment instruments like Foreign Direct Investment (FDI), Foreign Portfolio Investment (FPI), Foreign Venture Capital Investment (FVCI) etc., each governed by distinct regulatory and operational structures. This comparative analysis attempts to delineate fundamental differences between various foreign investment instruments by juxtaposing long-term strategic investment avenues with short-term market-linked instruments. This study attempts to evaluate the differences in the compliance obligations, sectoral caps, entry routes, risk profiles, and market impact associated with each kind of instrument.

KEY WORDS: Foreign investment, Economic reforms, Foreign Direct Investment, Foreign Portfolio Investment, Foreign Venture Capital Investment

## **INTRODUCTION**

Foreign investment refers to the cross-border movement of capital that contributes to economic development, technological progress, and employment generation in the recipient country. India employs a range of foreign investment instruments—debt, non-debt, and hybrid—each designed to cater to varying investment goals, risk preferences, and levels of control. The legal framework governing foreign investments is primarily established under Section 6(2)(A) and Section 47 of the Foreign Exchange Management Act, 1999 (FEMA), together with the Foreign Exchange Management (Non-Debt Instruments) Rules, 2019 (NDI Rules), which are periodically revised through gazette notifications to accommodate evolving economic conditions<sup>1</sup>. Indian entities may raise foreign capital by issuing equity shares, convertible

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<sup>1</sup> Reserve Bank of India, “Master Direction- foreign investment in India “,1,(2017-18)

debentures, or preference shares consistent with FEMA's pricing and valuation norms. Non-convertible, optionally convertible, and partially convertible preference shares must adhere to the External Commercial Borrowings (ECB) guidelines, while only fully and mandatorily convertible debentures qualify as equity under the Foreign Direct Investment (FDI) regime<sup>2</sup>.

### **Foreign Direct Investment (FDI)**

Foreign Direct Investment (FDI) denotes a long-term investment by a foreign entity seeking both financial returns and managerial control over a company operating in another country. Typically, FDI involves acquiring at least 10% ownership in a foreign enterprise, representing strategic intent rather than mere portfolio participation. In India, FDI is recognized only when made through equity shares, compulsorily convertible debentures or preference shares, and share warrants issued by Indian companies. This investment route combines capital infusion with active involvement in enterprise operations, distinguishing it from other passive forms of foreign investment.

India's FDI framework provides two channels for investors: the Automatic Route and the Government Route. Under the Automatic Route, sectors such as agriculture, petroleum, manufacturing, e-commerce, rail infrastructure, and pharmaceuticals are open to investment without prior government or RBI approval. The Government Route mandates prior approval for investments in sensitive areas like defence, broadcasting, civil aviation, telecommunications, satellites, and private security. Several sectors—including lottery, gambling, real estate trading, and tobacco production—remain completely prohibited, while strategic fields like atomic energy and railway operations are reserved for the public sector<sup>3</sup>.

Recent liberalization steps by the government aim to create a transparent and investor-friendly environment, with over 90% of FDI now flowing through the Automatic Route. Key reforms have targeted defence, telecom, insurance, energy, and space sectors—gradually easing foreign equity restrictions. For example, insurance caps were raised from 49% to 74%, with proposals under the 2025 Union Budget to extend this to 100% for firms reinvesting profits domestically.

### **DOWNSTREAM INVESTMENTS**

Downstream investments or indirect foreign direct investment refers to investments made by

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<sup>2</sup> Peter gratton "Foreign investment: definition, how it works and types", Investopedia, available at: <https://www.investopedia.com/terms/f/foreign-investment.asp> (last visited on:08-09-2025)

<sup>3</sup> Department for Promotion of Industry and Internal Trade Ministry of Commerce and Industry(DPIIT), "consolidated FDI Policy", available at: [https://dpiit.gov.in/sites/default/files/FDI-PolicyCircular-2020-29October2020\\_0.pdf](https://dpiit.gov.in/sites/default/files/FDI-PolicyCircular-2020-29October2020_0.pdf) (last accessed on: 08-09-2025)

an Indian company, owned or controlled by non-residents, into another Indian company. Downstream investors must strictly adhere to all sectoral, entry route, investment caps, pricing guidelines and all other provisions of FDI policy applicable to foreign direct investors<sup>4</sup>.

The first-level Indian entity making the investment must ensure compliance with the Non-Debt Instruments (NDI) Rules for subsequent investment levels, supported by annual auditor certification. Any qualification by the auditor must be reported to the RBI's regional office. Additionally, the entity must file Form DI on the RBI FIRMS portal and inform the DPIIT within 30 days of the investment, irrespective of share allotment status<sup>5</sup>.

### **FOREIGN PORTFOLIO INVESTMENT (FPI)**

Foreign Portfolio Investment (FPI) involves passive foreign investment in financial assets such as stocks, bonds, and securities, without any controlling stake or managerial involvement in the investee company. Its primary purpose is to earn returns and diversify holdings, and it is marked by high liquidity that enables rapid market entry and exit. This sensitivity to short-term conditions has led to FPIs being termed "hot money." In India, FPIs are regulated under the SEBI (FPI) Regulations, 2019, with compliance overseen by the Securities and Exchange Board of India (SEBI) and registrations maintained by the National Securities Depository Limited (NSDL). In the 2024–25 fiscal year, the largest FPI inflows came from the United States, followed by Singapore.

FPIs are classified into two main categories. Category I covers government entities, sovereign wealth funds, international organisations, and regulated financial institutions. Category II includes endowments, charitable foundations, corporations, and eligible individuals. While individual FPI or related group holdings are capped at 10% of a company's paid-up equity capital on a fully diluted basis, aggregate FPI holdings in a company cannot exceed 24% of its paid-up equity or equivalent value in other eligible securities. FPIs with common ownership or control exceeding 50% are treated as a single entity for limit purposes.

Registration requires applicants to be residents of countries whose securities regulators are signatories to the IOSCO Multilateral Memorandum of Understanding or have bilateral MoUs with SEBI, and whose central banks are members of the Bank for International Settlements.

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<sup>5</sup> Reserve Bank of India, "Master Direction- foreign investment in India", 1, (2017-18)

They must be free from FATF warnings and meet SEBI's 'fit and proper' criteria. Registered entities in India's International Financial Services Centre (IFSC) may also act as FPIs.

Investment avenues for FPIs span equities such as listed or unlisted shares, exchange-traded derivatives, mutual fund units, IDRs, REITs, InvITs, and certain AIF units. Commodity derivatives (excluding agricultural commodities), offshore derivative instruments, and convertible notes from Indian startups are permitted, as are debt instruments including government securities, treasury bills, non-convertible debentures, commercial paper, mutual fund debt units, securitized instruments, municipal bonds, and rupee-denominated bonds for infrastructure. Acquisitions can be through public offerings or private placements, with pricing aligned to domestic investor rates for public issues and following FDI norms or fair valuation for private deals. Government approval is unnecessary when sectoral caps are maintained and there is no transfer of ownership or control to non-resident investors. FPIs must route trades through SEBI-registered brokers, except in certain exempted corporate bond transactions.

### **FOREIGN VENTURE CAPITAL INVESTMENT**

Venture capital refers to a form of seed funding where external investors provide capital to new, expanding, or struggling enterprises in exchange for equity ownership rather than fixed repayment. It differs from traditional bank loans as it enables investors to earn high returns through ownership stakes in businesses with high growth potential but limited operational history. In India, venture capital activities are governed by the Securities and Exchange Board of India (SEBI) and Foreign Exchange Management Regulations.

After receiving approval from SEBI and the Reserve Bank of India, FVCIs may invest in two main avenues, viz, Venture Capital Undertakings, which are newly incorporated, unlisted companies in India requiring capital and strategic support, and Venture Capital Funds, which are SEBI-registered entities pooling funds to invest in start-ups and emerging businesses. FVCIs may invest across specific sectors, including biotechnology, nanotechnology, seed research, pharmaceuticals, IT, biofuel production, the dairy and poultry industries, hotel-cum-convention centres, and infrastructure. Under Rule 11 of the FVCI Regulations, at least two-thirds of investible funds must be deployed in unlisted or equity-linked instruments of VCUs, with the remainder allowed in initial public offerings, debt instruments, or equity in financially weak listed firms. FVCIs may also allocate up to 100% of funds to SEBI-registered domestic

VCFs, provided they disclose investment strategies to SEBI beforehand.

Regulatory obligations under Chapter IV require FVCIs to maintain detailed records and accounts for at least eight years and share them with SEBI upon request. They must operate through an RBI-approved designated bank and appoint a domestic custodian to manage and report on their Indian investments. From a taxation perspective, venture capital funds and companies enjoy exemptions under Section 10(23FB) of the Income Tax Act, 1961, while Section 115(U) governs taxation on income distributed to investors. They also enjoy regulatory relaxations such as exemptions from pricing restrictions, lock-in periods post-listing, and takeover code obligations during divestment.

Exit strategies are a crucial aspect of venture capital investment, allowing investors to realize profits and withdraw funds efficiently. FVCIs are permitted to sell or purchase securities at mutually agreed prices without entry or exit restrictions, enhancing flexibility

### **Participatory Notes (P-Notes)**

Participatory Notes (P-Notes) are offshore derivative instruments enabling foreign investors to gain exposure to Indian securities without direct SEBI registration. Designed for convenience, they allow entities such as hedge funds, institutional investors, and high-net-worth individuals to access the Indian capital market quickly, bypassing the lengthy documentation and compliance requirements of direct registration<sup>6</sup>. In this arrangement, a SEBI-registered Foreign Institutional Investor (FII) or Foreign Portfolio Investor (FPI) acts as a conduit, purchasing Indian equities or other securities and then issuing P-Notes to the overseas client. While holders of P-Notes do not have direct ownership of the underlying securities, they still benefit from returns such as capital gains and dividends<sup>7</sup>.

The oversight of P-Notes falls under SEBI's regulatory ambit, which has progressively tightened rules to address concerns around anonymity and illicit fund flows. Because P-Notes historically allowed the identity of the ultimate investor to remain concealed, they raised risks of being misused for money laundering, black money inflows, and tax evasion. In response,

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<sup>6</sup> Vajiram and Ravi," Participatory Notes (P-Notes)" available at: <https://vajiramandravi.com/current-affairs/participatory-notes-p-notes/> (last accessed on 10-09-2025)

<sup>7</sup> Drishti IAS," Participatory Notes (P-Notes)", available at: <https://www.drishtiiias.com/daily-news-analysis/participatory-notes> (last accessed on 10-09-2025)

SEBI has strengthened its compliance framework through mandatory Know Your Customer (KYC) and Anti-Money Laundering (AML) norms. Issuers must now submit regular reports detailing the issuance of P-Notes, including complete information on the ultimate beneficial owners, a significant departure from earlier practices where such disclosure was optional.

SEBI has also imposed operational restrictions, notably banning the use of P-Notes for speculative investments in equity derivatives, except where they serve hedging objectives. These reforms aim to foster foreign investment while protecting market integrity, ensuring transparency, and maintaining a robust check on potentially harmful capital flows.

For investors, Participatory Notes (P-Notes) offer several advantages, including simplified access to the Indian market, lower costs by avoiding registration fees, and the ability to invest while maintaining anonymity. However, they come with notable risks. Since a P-Note's worth is directly linked to the performance of the underlying Indian security, holders face the same market volatility and potential losses as direct investors. Additionally, abrupt regulatory changes can sharply reduce P-Note values and trigger capital outflows, potentially unsettling the broader market. Due to their sensitivity, the proportion of P-Notes within total foreign investments is under continuous scrutiny by both regulators and market participants.

### **Overseas Direct Investment (ODI)**

Overseas Direct Investment (ODI) refers to financial commitments made by Indian companies or individuals in foreign business ventures with the objective of obtaining substantial ownership or control. Such investments may take the form of equity capital, loans, or guarantees and are subject to regulatory limits, such as 400% of the Indian entity's net worth. Common modes of investment include purchasing shares, subscribing to the Memorandum of Association (MoA) of a foreign entity, or providing financial assistance to overseas ventures. However, these investments must comply with the conditions laid down by the Reserve Bank of India (RBI).

Overseas Direct Investment may be undertaken through two primary routes: the Automatic Route and the Approval Route. Under the Automatic Route, eligible Indian entities such as Indian-incorporated companies, statutory bodies, registered partnerships, or other RBI-notified entities may invest abroad without prior approval from the RBI by submitting Form ODI to an Authorized Dealer Category-I bank. When multiple such entities invest jointly in a foreign

business, they are collectively regarded as one “Indian Party.” Conversely, investments not qualifying under the Automatic Route require RBI’s prior approval through the Approval Route. This applies particularly to investments in sectors like real estate, banking, financial services, or energy and natural resources that exceed 100% of net worth, as well as overseas oil sector ventures by entities other than specified public sector undertakings. Investments by registered trusts or societies in manufacturing, education, or healthcare also need prior approval. Moreover, all overseas investments must obtain a Unique Identification Number (UIN) from the RBI. Listed Indian companies may additionally invest up to 50% of their net worth in listed foreign securities carrying an investment-grade rating.

An Indian Party making overseas investments must meet certain ongoing compliance requirements. It must obtain share certificates or other valid proof of investment in the foreign entity within six months and submit them to the designated Authorized Dealer (AD). All receivables, such as dividends, royalties, and technical fees from the foreign entity, must be repatriated to India. Each year, an Annual Performance Report in Part III of Form ODI must be filed through the designated AD with the Reserve Bank of India (RBI) for every joint venture (JV) or wholly owned subsidiary (WOS) established or acquired abroad<sup>8</sup>. Any decisions by the JV or WOS concerning diversification, creation of step-down subsidiaries, or changes in shareholding must be reported within 30 days of approval by the local competent authority; these details must also be included in the Annual Performance Report.

In the event of disinvestment, sale proceeds from shares or securities must be repatriated to India immediately upon receipt, and no later than 90 days from the sale date, with supporting documents submitted to the RBI through the designated AD. Certain activities are restricted or prohibited for overseas investments, including real estate trading (buying, selling, or trading in transferable development rights, though development projects like townships and infrastructure construction are allowed), gambling of any kind, and dealing in financial products linked to the Indian Rupee without prior RBI approval<sup>9</sup>.

### **Alternative Investment Funds (“AIFs”)**

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<sup>8</sup> RBI, “Master Circular on Direct Investment by Residents in Joint Venture (JV) / Wholly Owned Subsidiary (WOS) Abroad”, (2010), available at : <https://www.rbi.org.in/commonperson/english/Scripts/Notification.aspx?Id=720#b13>

<sup>9</sup> Id.

The SEBI (Alternative Investment Funds) Regulations, 2012 provide the framework for establishing and operating alternative investment funds (AIFs) in India that raise capital through private placements. These regulations allow AIFs to invest in securities of companies incorporated outside India, subject to compliance with guidelines issued jointly by the Reserve Bank of India (RBI) and SEBI. Historically, all SEBI-registered AIFs and venture capital funds (VCFs) shared a collective overseas investment cap, known as the Block Limit, set at USD 750 million. Following a recent revision, SEBI has doubled this cap to USD 1,500 million. Investment capacity within this limit is allocated on a first-come-first-served basis, depending on the availability of remaining quota. Moreover, regardless of the overall Block Limit, the 2015 SEBI Circular stipulates that any single AIF may deploy no more than 25% of its investible funds overseas.

Overseas investments by AIFs are permitted only in equity or equity-linked instruments of offshore venture capital undertakings, defined as foreign companies whose shares are not listed on any recognized stock exchange worldwide. AIFs are expressly prohibited from investing overseas in joint ventures or wholly owned subsidiaries. Eligible targets must have a discernible Indian connection that delivers indirect benefits to India, such as cases where a company's back-office operations are based in India but its front-office functions operate abroad. The definition of this "Indian connection" is not comprehensive, leaving SEBI to decide on eligibility case by case. All overseas investments must comply with the Foreign Exchange Management (Transfer or Issue of Any Foreign Security) Regulations, 2004 and all subsequent amendments, RBI directions, and guidelines, including those applicable under the Overseas Direct Investment (ODI) route.

To make overseas investments, AIFs and VCFs must secure prior approval from SEBI by submitting proposals in the format prescribed in the Annexure to the 2015 Circular. This approval process is now entirely online, and separate RBI approval is not required. Funds that have already been allotted overseas investment limits may apply for additional allocations by submitting a fresh application; however, such applicants will be considered on par with others without any allocation priority.

Once SEBI grants approval, the AIF or VCF must execute its investment in the offshore entity within six months. If the investment is not made within this stipulated period, SEBI has the authority to reallocate the unused quota to other applicants. Additionally, strict disclosure

requirements apply to ensure transparent monitoring of allocations and usage. Funds must report the utilization of the overseas limit within five working days via SEBI's intermediary portal. Where the allotted quota, either in whole or part, is unused after the six-month period, this must be reported to SEBI within two working days following expiry. If a fund decides to surrender its overseas limit, it must report the decision within two working days from the date of resolution.

### **External Commercial Borrowings (ECBs)**

External Commercial Borrowings (ECBs) refer to commercial loans availed by eligible Indian resident entities from recognized foreign lenders, including international banks and multilateral financial institutions, to finance their capital expenditure and working capital needs. These borrowings can be structured as bank loans, buyers' credits, or debt instruments such as bonds and may be denominated in freely convertible foreign currencies or Indian Rupees. ECBs play a pivotal role in supporting Indian corporate and public sector growth by offering access to relatively cheaper funds compared to domestic borrowings, thereby facilitating business expansion, infrastructure development, and acquisition of productive assets.

The Reserve Bank of India (RBI), in coordination with the Department of Economic Affairs under the Ministry of Finance, administers and supervises the ECB framework through the Master Direction on External Commercial Borrowings, Trade Credits, and Structured Obligations issued under the Foreign Exchange Management Act, 1999<sup>10</sup>. Eligible borrowers in India can raise funds from various foreign sources, including international financial institutions, overseas branches or subsidiaries, and foreign equity holders. Depending on the loan arrangement, ECBs may be either foreign currency-denominated, requiring repayment in that currency, or rupee-denominated, where repayment is made in India.

The regulatory mechanism governing ECBs is divided into two routes—the Automatic Route and the Approval Route. The RBI periodically reviews and modifies its ECB guidelines to align with evolving macroeconomic conditions and to maintain prudential external debt management within sustainable limits.

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<sup>10</sup> RBI, "Master Direction on External Commercial Borrowings, Trade Credits, and Structured Obligations issued under the Foreign Exchange Management Act, 1999"(2011), available at: <https://www.rbi.org.in/commonman/english/scripts/Notification.aspx?Id=968>

From a financial standpoint, ECBs present distinct advantages to Indian borrowers. They enable access to significant long-term funds at competitive interest rates and facilitate foreign currency financing for imports of capital goods, machinery, or technology. However, these benefits are accompanied by several inherent risks. Exchange rate risk is primary, as depreciation of the Indian rupee can substantially increase repayment obligations. Additionally, sovereign risk and credit risk may emerge depending on the stability of the borrowing entity's counterpart and the geopolitical situation of the lender's country. Regulatory risk also persists, arising from evolving RBI directives or government policies that may alter the cost structure or eligibility criteria for foreign borrowings. Despite these challenges, ECBs remain an essential component of India's external financing ecosystem, contributing to industrial growth, infrastructure expansion, and global financial integration.

### **Foreign Currency Convertible Bonds**

Foreign Currency Convertible Bonds (FCCBs) are hybrid financial instruments issued by companies in foreign currencies, allowing investors the option to convert them into equity shares of the issuing company at a predetermined price in the future. Initially, FCCBs function like conventional loans, carrying fixed coupon rates generally between 8% and 14% and maturing in about five years. In their early period, they operate primarily as debt securities, but later present the opportunity for conversion into equity. Their issuance in India is regulated under the Foreign Exchange Management Act (FEMA) and guided by Reserve Bank of India (RBI) policy<sup>11</sup>.

One key advantage of FCCBs is that they are unsecured, so companies are not required to pledge collateral, providing them with flexibility in capital structuring. Additionally, FCCBs are often listed on international exchanges, ensuring liquidity through active trading and enabling investors to buy or sell these bonds with ease.

Under the regulatory framework, the RBI governs FCCBs within the External Commercial Borrowings policy, prescribing conditions for issuance and redemption. FCCBs must have a minimum maturity period of five years, and call or put options may only be exercised after this period. They cannot be issued without warrants, and expenses associated with the issue are

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<sup>11</sup> CFI, "Foreign Currency Convertible Bonds (FCCB), available at <https://corporatefinanceinstitute.com/resources/finance/foreign-currency-convertible-bonds-fccb/>, (last accessed on: 10-09-2025)

capped at 4% of the total amount raised. Companies are barred from issuing fresh FCCBs when outstanding bonds are nearing maturity, ensuring prudent debt management. Redemption can take place either through conversion into equity shares or by repaying principal and interest in the denominated foreign currency. For larger FCCB issues, prior RBI approval may be necessary to proceed.

Interest payments on FCCBs are subject to a 10% tax deduction at source (TDS). If investors convert bonds into shares, this conversion is not treated as a capital gain event. Transfers of FCCBs between non-resident investors also generally avoid capital gains tax. These tax provisions make FCCBs attractive to certain categories of investors<sup>12</sup>.

### **Real Estate Investment Trusts (REITs)**

Real Estate Investment Trusts are specialized investment vehicles that allow individuals to invest in income-generating real estate assets without having to directly own or manage physical properties. Modelled somewhat like mutual funds, REITs pool capital from multiple investors to acquire, operate, and manage a diversified portfolio of commercial real estate such as office buildings, shopping malls, hotels, warehouses, and healthcare facilities<sup>13</sup>. The units of REITs are listed and traded on stock exchanges, providing investors with liquidity and an easy exit route similar to equity shares, unlike the generally illiquid nature of direct real estate investments.

The structure of a REIT typically involves a tripartite arrangement consisting of a sponsor, a management company, and a trust. The trust holds the real estate assets on behalf of the unit holders to safeguard their interests, while the management company oversees day-to-day operations and asset portfolio management. This framework establishes transparency and security for investors. REITs generate income primarily from rents collected on the properties they own, alongside capital gains from occasionally selling properties. Regulatory guidelines require REITs to distribute at least 90% of their net distributable cash flows to investors, making them attractive for those seeking stable and regular income streams, often in the form of dividends.

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<sup>12</sup> “Foreign Currency Convertible Bond (FCCB) Defined, How It Works”, Bond Bazar, available at: <https://www.bondbazaar.com/blog-detail/foreign-currency-convertible-bonds>, (last accessed on:10-09-2025)

<sup>13</sup> National Institute of Security Markets, “Understanding REITs”, available at : <https://www.nism.ac.in/understanding-reits/> (last accessed on:10-09-2025)

One of the major advantages of REITs is their accessibility to retail investors through relatively low minimum investment amounts. They also offer diversification benefits by allowing investors exposure to various types of real estate assets across geographic regions and sectors without the need to directly manage properties. In India, REITs are regulated by the Securities and Exchange Board of India (SEBI) under the SEBI (Real Estate Investment Trusts) Regulations, 2014, ensuring investor protection and market discipline<sup>14</sup>.

## **CONCLUSION**

Instruments of foreign investment play a pivotal role in facilitating cross-border capital flows and fostering global economic integration. These provide diverse avenues for investors and companies to participate in international markets. Together, these tools enhance market liquidity, promote capital formation, and provide investors with opportunities to diversify their portfolios internationally. The regulatory oversight by authorities such as the Reserve Bank of India and Securities and Exchange Board of India ensures investor protection, market transparency, and efficient capital allocation. Despite challenges such as regulatory complexity and market risk, foreign investment instruments remain critical for attracting global investment, enabling economic growth, and strengthening financial markets worldwide.

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<sup>14</sup> “What is REIT? Meaning, Benefits & How it works”, Kotak Mutual Fund, available at: <https://www.kotakmf.com/Information/blogs/what-is-reit> (last accessed on:10-09-2025)

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