

Why FEMA compliance in India should not be taken lightly?

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FEMA investigations

- In recent years, the Directorate of Enforcement (the “**ED**”) has significantly expanded its enforcement actions under the Foreign Exchange Management Act, 1999 (“**FEMA**”), particularly in respect of foreign direct investment (“**FDI**”) transactions.
- The ED’s approach has evolved from focusing solely on capital flow contraventions to examining whether the underlying business operations are consistent with sectoral conditions and the applicable FDI route.
- Investigations increasingly target sectors involving fintech, e-commerce, and hybrid platform models where sectoral classification may be ambiguous.
- Enforcement proceedings have intensified, especially if operational realities appear to differ from the declared business classification or the applicable investment route.

Initiation of an investigation and outcomes

- **Trigger events:** Investigations may be initiated upon receiving formal complaints, references from the Reserve Bank of India (the “**RBI**”), media reports, or as part of ongoing scrutiny and examination of submitted FDI filings.
- **Dissection of business models:** The ED examines actual functions, contractual arrangements, and fund flows to assess whether the business aligns with the sectoral classification under which FDI has been received.
- **Re-characterization:** Where discrepancies arise during the assessment, the ED may reinterpret the nature of the entity’s business activities by referencing the regulatory framework.
- **Enforcement action:** Post-investigation, the ED may initiate proceedings under Section 16(3) of FEMA, leading to adjudication and potentially exposing the entity to significant legal and reputational consequences.

“Substance Over Form”

- A central feature of the ED’s current enforcement approach is the emphasis on “substance over form.”
- The ED focuses on the actual conduct of an entity’s business and operational models, rather than relying solely on the descriptions, technical classifications, or stated objectives in documents such as the Memorandum of Association or regulatory filings.
- The ED assesses critical indicators such as fund flows, which party bears the commercial risk, the specific functions carried out, related-party interactions, and the broader impact on end consumers.
- This interpretative approach provides the ED with wide latitude to scrutinize the hybrid or platform-based business models.
- Merely categorizing activities as “information technology services” or “wholesale trading” does not provide immunity where the underlying business operations reflect characteristics of regulated or restricted activities.

Scrutiny against One Sigma Technologies Private Limited

- On July 23, 2025, the ED filed a complaint under Section 16(3) of FEMA against One Sigma Technologies Private Limited (the “**Company**”) and its director, alleging violations amounting to INR913.76 crore (Indian Rupees Nine Hundred Thirteen Crores and Seventy-Six Lakhs).
- The alleged violations relate to substantial FDI inflows from the US received under the 100% automatic route by classifying the business as “Benefits of Information Technology and other computer service activities.”
- The Company provides a digital platform and does not itself sell products or extend credit; however, it collects and holds customer payments on behalf of merchants, manages settlements, and maintains financial records.
- Accordingly, the ED concluded that the Company’s actual operations come under the category of “financial services not regulated by any financial sector regulator,” a sector in which FDI requires prior government approval.
- As the Company had received FDI without obtaining such approval, the ED filed a complaint under Section 16(3) of FEMA.

Investigations against Flipkart and Myntra

- In earlier enforcement actions, the ED has scrutinized the operational structures of entities such as Flipkart (a Walmart subsidiary) and Myntra.
- The ED filed a complaint against Myntra, its related companies, and directors for alleged FDI contraventions amounting to INR1,654 crore (Indian Rupees One Thousand Six hundred and Fifty-Four Crores).
- Myntra had received FDI by declaring itself a “wholesale cash & carry” entity but carried out multi-brand retail trading through its related party, Vector E-Commerce.
- Myntra sold 100% of its goods to Vector, which in turn sold these goods directly to consumers, effectively converting B2B transactions into B2C, violating FDI conditions.
- A similar structure was used by Flipkart via WS Retail, which led to a INR10,600 crore (Indian Rupees Ten Thousand Six Hundred Crores) FEMA complaint for FDI violations.
- In both the foregoing cases, the ED focused on the economic substance of operations rather than what was shown on paper, and issued show cause notices for violations of FDI sectoral conditions.
- As per recent press reports, the ED is willing to close the Flipkart case against compounding of the offence and payment of a penalty by Flipkart.

Risk mitigation and compliance measures

- **Classification analysis:** Entities must undertake a detailed review of their operational model, fund flows, and sectoral alignment before receiving foreign investment.
- **Approval route discipline:** Where sectoral classification or control structures fall within interpretative grey areas, seeking prior government approval is safer than unilaterally going through the automatic route.
- **Periodic review:** Regular FEMA audits should be undertaken by entities to identify any evolution of the business model that may give rise to compliance risks.
- **Cautious use of hybrid instruments:** Complex or layered financial structures, including convertible notes and affiliate or related party arrangements, should be reviewed carefully for FEMA implications.
- **Regulatory engagement:** Proactive engagement with the Department for Promotion of Industry and Internal Trade or the RBI can mitigate subsequent enforcement risks.

Thank You

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