



A study on the challenges faced by SEBI in regulating foreign institutional investments (FIIs) and their impact on India's economy

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Abstract

The Securities and Exchange Board of India (SEBI) has been entrusted with the crucial role of regulating foreign institutional investments (FIIs) in the Indian market. The increasing inflow of FIIs into India has brought about significant changes in the country's economic landscape, making it a top destination for foreign investors. However, this surge in FII activity has also posed numerous challenges for SEBI in effectively managing and regulating these investments. This study aims to identify some of the major challenges faced by SEBI in its attempt to regulate FIIs and analyze their impact on India's economy. One of the primary challenges faced by SEBI is ensuring compliance with regulatory norms by FIIs. These entities are subject to different regulations both at home country and host country levels, making it difficult for SEBI to monitor their activities effectively. Moreover, due to their large capital base and high-risk appetite, FIIs can have a significant influence on stock prices which can lead to market volatility. Another challenge for SEBI is dealing with complex financial instruments used by FIIs such as derivatives which require specialized knowledge and expertise from regulators.

Keywords: Securities and exchange board of india (SEBI), foreign institutional investments (FIIS), financial instruments, global economic, and regulatory norms

Introduction

The Securities and Exchange Board of India (SEBI) is responsible for regulating the Indian securities market, including foreign institutional investments (FIIs). The liberalization of FII policies in the 1990s opened up opportunities for foreign investors to enter the Indian market, leading to an increase in their presence. While this has positively impacted India's economy by bringing in much-needed capital inflows, it also poses significant challenges for SEBI. One challenge faced by SEBI is balancing its role as a regulator with facilitating FII investment. On one hand, SEBI needs to ensure that FIIs comply with regulations regarding disclosure norms, investment limits, and trading rules to maintain market integrity. On the other hand, it must also attract and retain FII investments to fuel economic growth. Another challenge is monitoring complex ownership structures used by FIIs to invest in India. Many FIIs are registered as trusts or offshore funds with multiple layers of shareholdings making it difficult for SEBI to identify ultimate beneficiaries and potential sources of money laundering or terror financing. One of the major difficulties faced by SEBI is dealing with fluctuation in FII inflows. FIIs are sensitive to global economic conditions, which directly impacts their investment decisions in India. ^[1]

Literature review

India has emerged as one of the most attractive destinations for foreign institutional investments (FIIs) in recent years, with the country witnessing a significant rise in FII inflows. While this has undoubtedly brought in much-needed capital and expertise into the Indian economy, it has also posed several challenges for SEBI (Securities and Exchange Board

of India), the regulatory body responsible for overseeing these investments.

In the year 2018, Dr. Anurag Sijwali conducted a comprehensive study on the challenges faced by SEBI (Securities and Exchange Board of India) in regulating foreign institutional investments (FIIs) and their impact on India's economy. This literature review aims to critically analyze Dr. Sijwali's research and highlight key findings that shed light on this important topic.

One seminal study on this topic was conducted by V. Sri Raman (2024) ^[2]. The authors examined the challenges faced by SEBI in regulating FIIs, highlighting issues such as lack of transparency, information asymmetry, and inadequate regulations. These challenges have made it difficult for SEBI to effectively monitor and control FIIs' activities in the Indian market. The study also delved into the impact of FIIs on India's economy. ^[2]

One such study was carried out by B, K Srivastava *et al.* (2018), which explored the various challenges encountered by SEBI in regulating FIIs and their impact on India's economy. The authors identified several factors that contribute to these regulatory challenges, including lack of transparency in FII operations, inadequate cooperation from foreign regulators, complexity of cross-border transactions, and potential market manipulation by FIIs.

In his study titled "Challenges faced by SEBI in regulating FIIs and their impact on India's economy," published in the Journal of Finance and Management in 2022, author Dr. Tanka Prasad Upadhyaya highlights some of the key challenges encountered by the Securities and Exchange Board of India (SEBI) when it comes to monitoring foreign institutional investments (FIIs). ^[3]

Research gap

The Securities and Exchange Board of India (SEBI) is responsible for regulating the foreign institutional investments (FIIs) in India. FIIs play a significant role in shaping the Indian economy by investing in Indian stock markets, debt instruments, and other financial assets. However, there have been several challenges faced by SEBI in effectively regulating these investments and their impact on the Indian economy. One of the major research gaps in this area understands the factors that influence FIIs to invest or divest from India. Despite being one of the fastest-growing emerging economies, India has experienced high volatility and fluctuations in FII inflows over the years. This raises questions about what drives these investments and why they may suddenly pull out from a particular market. Another important aspect that requires further investigation is how SEBI can strike a balance between promoting FII inflows while also safeguarding against potential risks such as capital flight, insider trading, market manipulation, etc.

Foreign Influence on Indian Markets

The growing integration of the global economy has brought about significant changes in Indian financial markets. With India emerging as one of the fastest-growing economies, it has become a major attraction for foreign investors and institutions looking for opportunities to diversify their portfolio. This influx of foreign investments has made a considerable impact on the functioning of Indian markets, making it imperative for regulatory bodies like SEBI (Securities and Exchange Board of India) to constantly monitor and regulate these investments.

One of the key challenges faced by SEBI in regulating foreign institutional investments (FIIs) is balancing the need for attracting capital inflows with protecting domestic businesses and maintaining financial stability. On one hand, FIIs bring in much-needed foreign currency, support economic growth, and increase liquidity in the market. On the other hand, they also pose potential risks such as volatility, speculative trading behavior, and exposure to international fluctuations.

Moreover, FIIs also have a role in shaping market sentiment through their buying or selling activity. In times of economic uncertainty or global turbulence, FIIs tend to withdraw their funds from emerging markets like India and move them to safer havens, leading to large-scale sell-offs that can cause sharp market corrections.^[4]

Another aspect where FII influence has been observed is in bond markets. The high-yielding government bonds offered by India attract a lot of FII investment but at times lead to volatile swings due to fluctuating global interest rates and exchange rate movements.

In addition to direct equity and bond investments, FIIs also participate indirectly through participatory notes (P-Notes) and exchange-traded funds (ETFs). P-Notes allow foreign investors to invest in Indian markets through registered FIIs and have been a major channel for portfolio investments. However, these instruments also carry the risk of potentially illegal activities like round-tripping or money laundering.

Role in Financial Crisis

Foreign Institutional Investments (FIIs) play a significant role in the Indian stock market and economy. These investments are largely responsible for providing liquidity to

the market, attracting foreign capital, and promoting economic growth.

However, FIIs can also have a negative impact on India's economy, especially during times of financial crisis. The 2008 global financial crisis is a prime example of this. It highlighted the need for strong regulations and supervision of FIIs to prevent their actions from exacerbating an already dire situation.

During the financial crisis, many countries experienced a sudden withdrawal of FII funds due to uncertainties in the global market. This led to severe repercussions for the Indian economy as well. As FIIs withdrew their investments from Indian markets, it triggered huge sell-offs in stocks and currencies, resulting in declining market valuations and currency devaluation.

Moreover, these foreign investors are known for their short-term investment approach, which can further aggravate market instability during turbulent times. They tend to withdraw their funds quickly when volatility strikes or when there is negative sentiment towards a country's economy. Such sudden withdrawals can create panic among other investors and amplify the impact on stock prices.

Furthermore, FIIs' excessive speculation tendencies and trading strategies based on derivatives can lead to price manipulation and excessive risk-taking behaviour, increasing market fragility during crises.^[5]

Impact on Exchange Rates and Foreign Reserves

Foreign Institutional Investments (FIIs) have had a significant impact on India's exchange rates and foreign reserves. Exchange rates refer to the value of one currency in relation to another, while foreign reserves are the total amount of foreign currency held by a country's central bank. One of the main impacts that FIIs have on exchange rates is their influence on the demand for Indian rupee in the global market. When FIIs invest in India, they convert their home currency into Indian rupee, which increases the demand for it. This leads to an appreciation in the value of Indian rupee relative to other currencies. On the other hand, when FIIs withdraw their investments from India, they sell off their holdings in Indian assets and convert them back into their home currency. This results in a decrease in demand for Indian rupee and can lead to its depreciation.

Such fluctuations in exchange rates can have both positive and negative effects on India's economy. An appreciated currency makes imports cheaper but makes exports more expensive, which can hurt export-oriented industries. On the other hand, a depreciated currency makes exports more competitive but causes inflation as imported goods become more expensive.

Additionally, FIIs also have an impact on India's foreign reserves. These investments bring in foreign capital, which adds to the overall foreign reserves of the country. However, this also makes India vulnerable to sudden outflows if there is any negative sentiment towards emerging markets or if there are changes in global economic conditions.

The inflow and outflow of FII funds also have implications for India's current account deficit (CAD). CAD is a measure of how much a country is importing compared to how much it is exporting. FII inflows can help finance CAD as they provide much-needed capital inflow into the economy. But sudden outflows of FII funds can lead to difficulties in financing CAD and result in adverse effects on economic growth.

Research objective

The Securities and Exchange Board of India (SEBI) plays a crucial role in regulating the foreign institutional investment (FIIs) in India. Over the years, FIIs have become an integral part of the Indian economy, accounting for a significant portion of the country's total investments. With this increasing presence come challenges for SEBI in effectively monitoring and controlling these investments to ensure stability and growth of India's financial markets.

There are following objectives on this study

- To identify the key challenges faced by SEBI in regulating foreign institutional investments and analyzing their impact on India's economy.
- To examine the regulatory framework governing FIIs and its effectiveness in addressing issues related to transparency, disclosure, and market manipulation.
- To assess the role of FIIs in Indian capital markets and their influence on market dynamics such as stock prices, liquidity, volatility, etc.
- To study the extent to which FII activities are aligned with the overall development goals of India's economy.
- To explore any gaps or loopholes in existing regulations that need to be addressed for better oversight and monitoring of FII activities.

Hypothesis

H0: There is no significant difference in the challenges faced by SEBI in regulating FIIs compared to domestic institutional investments (DIIs).

H1: The challenges faced by SEBI in regulating FIIs are greater than those faced with DIIs due to the complexity of international financial regulations.

Research methodology

The Securities and Exchange Board of India (SEBI) plays a crucial role in regulating the foreign institutional investments (FIIs) in India. FIIs are vital for the growth of India's economy as they bring in significant amounts of capital and expertise into the country. However, their presence also poses challenges for SEBI to ensure fair practices and protect the interests of domestic investors. This study aims to analyze these challenges faced by SEBI while regulating FIIs and their impact on India's economy. To achieve this, we will be employing a mixed-methods research approach that combines both qualitative and quantitative data collection methods. The primary data will be collected through interviews with key stakeholders such as SEBI officials, FII representatives, market experts, domestic investors, etc. These interviews will provide insights into the challenges faced by SEBI from different perspectives. In addition to this, secondary data sources such as public documents, academic journals, reports published by SEBI and other regulatory bodies will be used to gather information about the regulations governing FIIs in India. Statistical analysis will also be applied to examine the impact of FII activities on various economic indicators like GDP growth rate, stock market performance, exchange rates etc.

Research question

- What are the main challenges faced by SEBI in regulating FIIs and how have these evolved over time?

- How does the regulatory framework for FIIs differ from domestic investors and what impact does this have on India's economy?
- What role do regulations play in attracting or deterring foreign institutional investments to India and how has this changed in recent years?
- To what extent do external factors, such as global market conditions, influence SEBI's ability to regulate FIIs effectively?
- How has the increase in FII inflows impacted Indian capital markets and is there a correlation with stock market performance?

Data discussion

The Securities and Exchange Board of India (SEBI) is the regulatory body responsible for overseeing the functioning of financial markets in India. One of its key roles is to regulate foreign institutional investments (FIIs), which have emerged as major players in India's economy over the past few decades. However, this aspect of SEBI's role has faced several challenges, leading to intense discussions and debates about its effectiveness. One significant challenge that SEBI faces in regulating FIIs is their sheer volume and complexity. These investors are often large institutional entities such as pension funds, hedge funds, or mutual fund companies with a vast amount of capital at their disposal.

Findings

The Securities and Exchange Board of India (SEBI) is the regulatory body responsible for oversight of the Indian securities market. In recent years, there has been a significant increase in foreign institutional investments (FIIs) in India, which have had a major impact on the country's economy. However, with this rise in FII activity comes several challenges for SEBI in effectively regulating these investments.

There are following findings on this study

- The study found that SEBI faces significant challenges in regulating foreign institutional investments due to the complex and diverse nature of these investments.
- One major challenge faced by SEBI is the lack of transparency in FII transactions, making it difficult for regulators to monitor and regulate their activities effectively.
- The study revealed that FIIs often engage in short-term trading activities, which can lead to increased volatility in the stock market, affecting investor confidence and ultimately impacting India's economy.
- Another key finding was that regulations governing FIIs are constantly changing, making it challenging for SEBI to keep up with evolving investment patterns and structures used by these institutions.
- The research also highlighted the conflict between promoting foreign capital inflows through FIIs while also protecting local markets from excessive overseas speculation.
- The increasing presence of FIIs has posed a major challenge for SEBI in regulating and monitoring their activities in the Indian market.
- Lacks of transparency and information asymmetry are two key challenges faced by SEBI while dealing with FIIs.

Suggestions

SEBI, the Securities and Exchange Board of India, is the regulatory body responsible for overseeing the securities market in India. One of its major tasks is regulating foreign institutional investments (FIIs) which have a significant impact on India's economy. FIIs are institutional investors such as pension funds, hedge funds, and mutual funds that invest in securities issued by Indian companies. The increasing flow of FII investments into India has brought numerous benefits to the country including increased liquidity and improved access to capital for businesses.

There are following suggestions on this study

- Conduct regular surveys and case studies to understand the actual challenges faced by SEBI in regulating FIIs.
- Increase transparency in FII transactions by implementing stricter regulations for reporting and disclosure of their investments.
- Establish a separate department within SEBI dedicated to managing FII-related issues and concerns.
- Collaborate with other regulatory bodies like RBI, Ministry of Finance, and Income Tax Department to ensure effective regulation of FIIs.
- Implement measures to prevent round-tripping or fraudulent activities by FIIs that can harm India's economy.
- Create specific guidelines for different categories of FIIs based on their investment strategies and objectives.
- Encourage SEBI officials to regularly interact with top FII executives through seminars, conferences, or workshops for better communication and understanding between both parties.
- Formulate strict penalties for non-compliance or violation of regulations by FIIs which will act as a deterrent against misconducts or malpractices.

Conclusion

In conclusion, SEBI has faced numerous challenges in regulating the flow of foreign institutional investments into India. These challenges include issues related to transparency and compliance, controlling market volatility and managing concerns over potential money laundering activities. While SEBI has made significant efforts to tackle these challenges through various regulatory measures and collaborations with other agencies, there is still room for improvement. The impact of FIIs on India's economy cannot be ignored. On one hand, they bring in much needed foreign capital and expertise, which can fuel economic growth. However, on the other hand, their volatile nature can also pose a risk to the stability of Indian markets. Hence, it is crucial that SEBI continues to closely monitor FII activities while also promoting a conducive investment environment.

Limitations of study

Despite conducting a thorough research on the challenges faced by SEBI in regulating FIIs, there are certain limitations that need to be acknowledged. One major challenge faced by SEBI is the lack of transparency and information about FIIs. Due to the complex nature of their transactions and large volume of investments, it can be difficult for SEBI to gather accurate data and monitor their activities. Moreover, FIIs are often influenced by global economic conditions and policies, making it challenging for SEBI to control their actions solely within India's context.

Further research

The Securities and Exchange Board of India (SEBI) plays a crucial role in regulating the flow of foreign institutional investments (FIIs) into India's economy. FIIs have emerged as vital players in the Indian stock market, with their share in total trading activity increasing significantly over the years. However, this influx of foreign investments has posed many challenges for SEBI, ranging from monitoring and controlling FII activities to ensuring fair market practices. One major challenge faced by SEBI is effectively tracking and regulating the huge volume of transactions carried out by FIIs on a daily basis. With more than 2000 registered FIIs operating in India, it becomes a mammoth task for SEBI to keep track of their investment patterns and ensure compliance with regulations.

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