

Substance Over Form: The ED's Scrutiny of Myntra's FDI Structure

The Enforcement Directorate (ED) has recently initiated adjudication proceedings under the Foreign Exchange Management Act, 1999 (FEMA) against Myntra Designs Pvt. Ltd. and its associated entities. The proceedings arise from a show-cause notice alleging contraventions of India's Foreign Direct Investment (FDI) policy, with the quantum of the transactions under scrutiny amounting to approximately ₹1,654.35 crore. This matter brings to the forefront the critical examination of corporate structures within the e-commerce sector, particularly those designed to navigate the nuanced distinction between wholesale and multi-brand retail trading.

The Regulatory Dichotomy: Wholesale vs. Multi-Brand Retail

To appreciate the legal basis of the ED's action, one must consider the dualistic FDI framework for trading activities. The extant FDI policy permits 100% foreign investment via the automatic route in the "Cash & Carry Trading/Wholesale Trading" sector. This permission, however, is subject to specific conditions, the most pertinent of which is the cap on sales to group companies. As per the Consolidated FDI Policy, a wholesale venture is permitted to effectuate sales to its group companies only up to 25% of its total turnover. The intent is to ensure that the entity is genuinely engaged in a Business-to-Business (B2B) model.

In stark contrast, FDI in Multi-Brand Retail Trading (MBRT) is highly regulated and subject to significant conditionalities, including caps on investment and state-level approvals.

The Alleged Modus Operandi

The ED's investigation focuses on the corporate structure employed by Myntra. It is alleged that Myntra Designs Pvt. Ltd., the recipient of foreign direct investment, operated ostensibly as a wholesale trading entity. However, instead of primarily supplying to unrelated businesses, it allegedly routed nearly its entire inventory to a related group entity, Vector E-Commerce Pvt. Ltd. This second entity then conducted the final Business-to-Consumer (B2C) sales to customers through the 'Myntra' e-commerce platform.

The core of the alleged contravention is that this structure effectively allowed Myntra to engage in MBRT under the guise of a wholesale business, thereby circumventing the stringent FDI norms applicable to the former. The alleged sale of nearly 100% of its goods to a group company constitutes a direct and substantial breach of the 25% cap, which is a condition precedent for a wholesale entity.

Legal Scrutiny and the Doctrine of Substance

The proceedings initiated by the ED are likely to be founded on the legal doctrine of "substance over form." The Directorate will contend that the two-step transaction (Myntra to Vector, then Vector to consumer) is an artificial arrangement, and the economic reality is that of a single, integrated retail operation funded by foreign capital in a manner not permitted by law.

Any contravention of the conditions of the FDI policy is deemed to be a contravention of FEMA itself, pursuant to Section 6(3) of the Act read with the Foreign Exchange Management (Non-debt Instruments) Rules. The ED, therefore, is empowered to investigate such breaches and recommend the imposition of penalties, which can be up to three times the sum involved in the contravention.

Implications for the E-commerce Sector

This case serves as a significant cautionary tale for the e-commerce industry and foreign investors in India. It underscores that regulatory bodies are increasingly piercing complex corporate veils to scrutinise the substantive nature of business operations. Compliance cannot be limited to formal documentation but must extend to the spirit and intent of the governing regulations. The final outcome of the adjudication in the Myntra matter will undoubtedly establish a crucial precedent for FDI compliance and corporate governance within India's rapidly evolving digital economy.