Foreign Portfolio Investment in India: SEBI creates a new class of investors

Introduction

In order to harmonize the various available routes for foreign portfolio investment in India, the Indian securities market regulator i.e. Securities Exchange Board of India (**"SEBI"**) has introduced a new class of foreign investors in India known as the Foreign Portfolio Investors (**"FPIs"**). This class has been formed by merging the existing classes of investors through which portfolio investments were previously made in India namely, the Foreign Institutional Investors[1] (**"FIIs"**), Qualified Foreign Investors[2] (**"QFIs"**) and sub-accounts[3] of the FIIs. Previously portfolio investment was governed under different laws i.e. the SEBI (Foreign Institutional Investors) Regulations, 1995 (**"FII Regulations"**) for FIIs and their sub-accounts and SEBI circulars dated August 09, 2011 and January 13, 2012 governing QFIs, which are now repealed under the SEBI (Foreign Portfolio Investors) Regulations (**"FPI Regulations"**) that govern FPIs. SEBI has, thus, intended to simplify the overall operation of making foreign portfolio investments in India.

Essentially, foreign portfolio investment entails buying of securities, traded in another country, which are highly liquid in nature and, therefore, allow investors to make "quick money" through their frequent buying and selling. Such securities may include instruments like stocks and bonds, and unlike shares, they do not give managerial control to the investor in a company. To govern FPIs, SEBI introduced the FPI Regulations by a notification[4] dated January 7, 2014. In this newsletter, we will discuss the legal framework that will govern FPIs, how FPIs will be taxed and the effect of this new regime on foreign portfolio investment in India.

1. The FPI Regulations

(a) Classification based registration of investors

FPI has been defined under FPI Regulation 2(h) as a person meeting the eligibility criteria specified under Regulation 4 (covered under (b) below) and duly registered under Chapter II and are considered as intermediaries for the purposes of SEBI Act, 1992. Under FPI Regulation 5 the following three categories of FPIs have been created on the basis of associated

[1] SEBI (Foreign Institutional Investors) Regulations, 1995 define FII under regulation 2(f) as an institution established or incorporated outside India that proposes to make investments in India

[2] QFIs are defined under SEBI circular No. CIR/IMD/DF/14/2011 dated August 9, 2011 as foreign investors who are entitled to invest in equity and debt schemes of Mutual Funds in India and are resident in a country that complies with the Financial Action Task Force standards and is also signatory to International Organization of Securities Commission's Multilateral Memorandum of Understanding

[3] Sub-accounts are defined under regulation 2(k) of SEBI (Foreign Institutional Investors) Regulations 1995 as any person resident outside India on whose behalf investments are made by FIIs in India and who is registered as sub-account under these regulations. They include foreign corporate, foreign individual, broad based funds or portfolios established or incorporated outside India

[4] Notification No. LAD-NRO/GN/2013-14/36/12

risks - **(a) Category I** includes foreign investors related with the government such as central banks, government agencies, sovereign wealth funds; **(b) Category II** includes regulated entities like banks, assets management companies, investment managers etc. and broad-based funds, which may be regulated such as mutual funds, investment trusts etc. or non-regulated; and **(c) Category III** includes investors, which are not covered under categories I and II.

The registration requirements are progressively difficult depending on the category under which the investor falls with easiest formalities for category I investors. Unlike the previous situation wherein the QFIs, FIIs and their sub-accounts were required to register with SEBI for 1-5 years initially to operate, FPIs registration is carried out by SEBI designated depository participants[5] (**"DDPs"**) on permanent basis unless suspended or cancelled.[6] These changes may tend to ease out the initial approval process for FPIs and subsequent operation by them compared to the previous situation.

(b) Eligibility criteria for FPIs

FPI Regulation 4 prescribes the mandatory eligible criteria for registration as FPI. Here, the applicant must be a non-resident in India but non-resident Indians (**"NRIs"**) are specifically prohibited. While this spells "bad news" for NRIs, a fund having NRIs as its investors can operate as a FPI as stated by SEBI. Further, the applicant is required to be a resident[7] of a country which meets the following criteria- **(i)** its securities market regulator is a signatory to the International Organization of Securities Commission's Multilateral Memorandum of Understanding[8] or party to an MOU with SEBI; **(ii)** whose central bank is a member of the Bank for International Settlements[9] in case if the applicant is a bank; and **(iii)** not mentioned in the public statement of Financial Action Task Force[10] as a country having issues related to combating financing of terrorism or money laundering.

The applicant must also be authorized to invest as per the law of its country of incorporation or place of business and as per its Memorandum of Association and Articles of Association or any other equivalent document. Borrowing from the FII Regulations, the following conditions have been made applicable for registration as a FPI - **(i)** the applicant must have sufficient experience, professional competence, good track record, financial soundness and a reputation for fairness and integrity; **(ii)** must meet the criteria specified in the SEBI (Intermediaries) Regulations, 2008 and **(iii)** grant of registration to the applicant must be

[5] Regulation 3(1) states that no person can buy, sell or otherwise deal in securities as a foreign portfolio investor unless a certificate to that effect has been granted by the designated depository participant on behalf of SEBI

[6] Regulation 10(2) of the FPI Regulations states that suspension or cancellation of the registration would be dealt with by the DDP in the manner indicated in Chapter V of the SEBI (Intermediaries) Regulations, 2008

[7] Explanation to Regulation 4 states that the terms "resident" and "non-resident" have to be interpreted as per their meanings stated under the Income Tax Act, 1961

[8] IOSCO is an international body that was established in 1983 in Madrid, Spain and seeks to develop and promote standards for regulating securities' markets of different countries to enhance investor protection at a global level. The Multilateral MOU was formulated by IOSCO in 2002 to promote co-operation and information exchange among its members to prevent practices as fraud, price manipulation and insider trading

[9] The Bank for International Settlements is headquartered in Basel, Switzerland that aims to ensure monetary and financial corporation at an international level among central banks of different countries

[10] Financial Action Task Force is an inter-governmental body formed in 1989, which aims to set global standards and policies aimed at combating money laundering and terrorist financing activities and it is headquartered in Paris

in the interest of development of the securities market. SEBI may specify any other criteria from time to time.

(c) Instruments available for investment and prescribed limits

FPI Regulation 21 provides for the type of instruments in which FPIs can invest. FPIs can invest in instruments such as listed or to be listed shares, government securities, units of mutual funds or collective investment schemes, treasury bills, corporate debt and Indian depository receipts. For foreign corporates and foreign individuals, the investment limit now stands increased from 5 to 10% of a company's total issued capital. Also, investment in equity shares which was previously permissible up to 10% of a company's total issued capital is now restricted to below 10%. FPI Regulations prohibit investments in unlisted equity shares of a company but the existing investments in such securities in which investment is now prohibited can be kept as such till the sale of such securities. Investment process for QFIs is easier under the FPI regulations as they can now, while operating as FPIs, issue investment instructions directly to their stockbrokers instead of doing it through qualified depository participants.[11] They may also now invest in additional instruments such as derivatives.

FPI Regulation 22 has brought a major change relating to issuance of Offshore Derivative Instruments[12] (**"ODIs"**). ODIs are significant because they allow foreign investors, such as high net worth individuals and hedge funds based overseas, to invest in the Indian market without being registered with the SEBI. Now, only FPIs, which are regulated and also fall under Category I or II can issue ODIs. Under the FII Regulations, ODIs could be issued by all FIIs other than sub-accounts. Also, unregulated funds cannot subscribe to ODIs now even if being managed by an appropriately regulated investment manager which was allowed earlier. A large number of unregulated hedge funds based in Cayman Islands managed by regulated investment managers shall be hit by this move. The investor base in ODIs may, thus, get significantly reduced. After receiving huge opposition from existing FIIs on this change, SEBI clarified that the new regulations will not affect existing ODI investments. The FPI Regulations, however, do not define the expression "persons who are regulated by an appropriate foreign authority", thus bringing in the need for more clarity in this regard.

2. Taxation of FPIs

After the FPI Regulations came in force, confusion prevailed among India Inc regarding the taxation of FPIs. This was because the different classes of investors were taxed differently previously and there was no clarity as to how the merged FPI will be taxed. The Central Board of Direct Taxes (**"CBDT"**) came out with a notification[13] dated January 22, 2014 deeming FPIs registered under the FPI Regulations as FIIs for taxation purposes. The notification indicates that all investor classes forming the FPIs would be taxed similarly to FIIs. QFIs are taxed at the rates of 40% and 20% on short term capital gains and long term capital gains, respectively arising from transfer of securities, which are lower for FIIs under the Income

[11] http://www.thehindubusinessline.com/features/investment-world/melange/one-window-for-foreign-investors-is-a-welcome-move/article5645803.ece last accessed on August 16, 2014

[12] Defined under regulation 2(j) as any instrument issued overseas by a FPI against underlying securities held by it that are listed or proposed to be listed on any recognized stock exchange in India

[13] Notification No. 9/2014

Tax Act, 1961 (**"Tax Act"**), i.e. 30% for short term capital gains and 10% for long term capital gains.[14] Similar tax treatment shall, thus, benefit QFIs through lower taxation under the new law. However, since the CBDT notification applies FII tax treatment to FPIs only for purposes of section 115AD of the Tax Act, applicability of tax benefits that FIIs enjoy under other provisions such as section 196D[15] to FPIs remained unclear.

The Indian Budget for the year 2014-15 classified income arising to FPIs from securities' transactions as capital gains.[16] As such, any securities held by a FPI would be regarded as a "capital asset" as defined in section 2(14) of the Tax Act so as to treat any income arising from transfer of such security as a "capital gain". This move ends the existing uncertainty on classification FPIs' income from their Indian investments as "business income" or "capital gains". Tax authorities classify this income as business income, which is taxed at higher rates than capital gains under the Tax Act, thus, leading to friction between the tax authorities and foreign investors. The new clarity in classification of FPIs' income favors FPIs based out of countries having favorable tax treaties with India such as Mauritius or Singapore under which capital gains are exempt from taxation. On the other hand, FPIs of other countries shall face additional tax burdens. This is because now they cannot show their income earned from securities' transactions as "business income" to avoid paying taxes under the pretext that business income is not taxable in absence of a business connection or permanent establishment of the foreign investor in India as per the Tax Act.

3. Implementation timeline

The FPI regime has greatly increased the roles and responsibilities of the DDPs. Naturally, availability of adequate infrastructure and facilities with these local custodians is important for a proper implementation of the law. Based on representations received from DDPs in this regard, SEBI issued a circular[17] dated March 28, 2014 extending the timeline for implementation of the FPI regime to June 1, 2014. It was further clarified that SEBI would continue to accept applications for registration as FIIs or their sub-accounts till May 31, 2014 after which the same would be handled by DDPs. This delay in implementation to give DDPs time to prepare for their additional responsibilities is understandably better than penalizing them for non-performance of their duties.

Conclusion

With the ease in registration requirements and clarity on taxation being brought in for FPIs, the new FPI regime is likely to boost portfolio investments in India by foreign investors. Granting of permanent registrations to FPIs shall not require them to approach the DDPs time and again for the same, thus, providing them a more supportive environment for investment in India. Meanwhile, with the delegation of work to DDPs, SEBI can now focus on more

[14] As stated under section 115AD(1) of the Tax Act

[15] Section 196D prohibits deduction of tax at source from income payable to an FII by way of capital gains on transfer of securities

[16] Under paragraph 201 of part B(XII) of the Budget, full text of the Budget 2014-15 available at http://zeenews.india.com/business/indian-budget-2014/union-budget-2014-15-full-text_103644.html (last visited on August 7, 2014)

[17] Circular No. CIR/IMD/FIIC/6/2014

important issues at hand requiring its attention and perform its regulatory role more effectively. It can be argued that the shift to the new regime, for all classes of investors that have been merged, shall be a comfortable one particularly because a buffer period has been given to them to operate without needing them to immediately comply with the formalities and process for conversion to and operation as FPIs.[18]

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[18] Regulation 3(1) of the FPI Regulations allows existing FIIs and sub-accounts to operate till expiry of their registration with SEBI and QFIs can also operate for a period of 1 year after commencement of the regulations subject to them obtaining registration as a FPI earlier than the expiry of the registration or end of the 1 year period respectively