New Regime for Foreign Portfolio Investment

Foreign portfolio investment, where foreign investors hold securities and other financial assets, does not provide any direct ownership of their financial assets to the investors. Such a relatively-liquid investment depends on the market's volatility. Most commonly used by investors who do not wish to manage a foreign firm, the investment generally is about short-term involvement in the international stock and bond markets, at times only for conjecture, is not very different from domestic investments in securities, conceptually. Despite having no direct management powers, foreign investors can still participate in the profitability of their firms. Read on this article, to understand the intricacy of the subject and new perspectives that have come to the fore in recent times…

1. Background

Ever since India embarked on the path of liberalisation and economic reforms a couple of decades ago, the Government of India (GOI) has been keen to attract foreign capital and investment. First among the changes was the opening up of the Indian capital markets to foreign investors and that's when, in September 1992, the GOI announced for the first time the policy framework for *foreign institutional investor* permitting them to invest in the Indian listed entities which regime subsequently culminated into the Securities and Exchange Board of India (Foreign Institutional Investors) Regulations 1995 (FII Regulations). Since then, the flow of funds from foreign institutional investors (FIIs) has given an impetus to the Indian capital markets. Additionally, the sustained nature of the FII investments has reiterated their belief in India's growth story, thus sending strong positive signals about the prospects of India as an investment destination to the global investment community.

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2. Regulatory Framework for Foreign Investment in India

Currently, foreign investors are allowed to invest in the Indian capital markets through different investment windows[1], each of which has its own regulatory framework, licensing/registration requirements and investment conditions. This makes the regulatory landscape in India rather complicated when compared to that of other emerging markets. Investment by the FIIs in India is jointly regulated by the securities market regulator, SEBI, through the SEBI (Foreign Institutional Investors) Regulations, 1995 and by the nation's financial regulator, the RBI, through the Regulation 5(2) of the Foreign Exchange Management Act (FEMA), 1999.

In 2011, the GOI in consultation with the RBI and SEBI, decided to allow a new category of investors,

[1] *Foreign investment in India is primarily channelised in three forms—foreign direct investment, portfolio investment scheme and foreign venture capital investment. Under foreign portfolio investment route, entities that are allowed to invest are foreign institutional investors and sub-accounts, non-resident Indians/persons of Indian origin, and qualified foreign investors.*

termed as *qualified foreign investors*[2] (QFI) under the portfolio investment route, who meet the KYC norms, to directly invest in Indian equity, corporate bonds and mutual fund schemes. In order to reduce the overall complexity and number of regulations governing inbound investments, SEBI has recently notified the SEBI (Foreign Portfolio Investors) Regulations, 2014 (FPI Regulations), which have come into force with effect from 7th January, 2014[3] replacing the existing FII Regulations. The RBI has recently issued a Circular[4] and notified[5] the amendments to the Foreign Exchange Management (Transfer or Issue of Security by a Person Resident Outside India) Regulations, 2000, regarding the framework for the FPIs to implement portfolio investments in Indian securities.

The FPI Regulations aim to rationalise foreign investments made into India by the portfolio investors such as the FIIs and QFIs. Following are some of the significant features of the FPI Regulations:

- Designated Depository Participants[6] (DDPs) (and not SEBI) to grant registration to the FPIs.
- Registration as an FPI can be obtained in one of the three categories specified by the SEBI.
- Registration granted to an FPI shall be permanent unless suspended or cancelled by the SEBI or surrendered by the FPI.
- Total holding by each FPI shall be below 10 % of the total paid-up equity capital or 10 % of the paid-up value of each series of convertible debentures issued by an Indian company and the total holdings of all the FPIs put together shall not exceed 24 % of the paid-up equity capital or paid-up value of each series of the convertible debentures.
- In case the same set of ultimate beneficial owner(s) invest through multiple entities, these entities shall be treated as part of the same investor group and the investment limits of all such entities shall be clubbed at the investment limit as applicable to a single foreign portfolio investor.
- The FPIs are permitted to issue, subscribe or deal in offshore derivative instruments where the same is issued to persons regulated outside India. However, Category III FPI and unregulated broad-based funds (classified as Category II FPIs by virtue of their investment manager being appropriately regulated) are not permitted to issue, subscribe or deal in ODIs.

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3. Regulatory Differences

Set out below is the broad summary of differences between the FII/QFI Regulations and the new FPI Regulations:

FII / QFI Regime	FPI Regime
Foreign Investments in India	
Foreign investment in India is characterised by multiple routes like FIIs, QFIs, *etc.*, and various regulators overseeing these routes, overlapping policies, complicated tax structures, and high cost of transactions leading to inconsistencies, reduced transparency and higher capital costs.	The new policy provides for a single route for various Foreign Portfolio Investors by merging the present day FIIs, Sub-Account and QFIs into a new investor class termed as *Foreign Portfolio Investor* (FPI) where there will be common market entry, limit monitoring and reporting norms.

[2] *Qualified foreign investors have been defined as persons who are not registered with the SEBI as FIIs/sub-accounts of an FII and are residents of a country that is compliant with the Financial Action Taskforce Standards and are signatory to the International Organisation of Securities Commission's Memorandum of Understanding.*

3 *SEBI has recently issued a circular extending the date of commencement of the FPI regime to* ***1st June 2014****.*

[4] *AP (DIR Series) Circular No. 112, dated 25th March, 2014.*

[5] *Notification No. FEMA 297/2014-RB, dated 13th March, 2014.*

[6] *Designated Depository Participant means a person who has been approved by SEBI under Chapter III of these regulations.-A*

FII / QFI Regime	FPI Regime
FIIs and Sub Accounts	
FII route includes FIIs and Sub-Accounts. Under the QFI route, investors including individuals, corporates, private banks, Funds *etc*., can invest on fully repatriable basis in schemes of domestic mutual funds, listed equity shares of the Indian companies and debt securities.	FIIs and QFIs route merged into a single investment window, called the FPI window. SEBI has done away with the concept of Sub-Accounts.
Licensing Requirements	
FII, Sub-Accounts were required to register with SEBI before making investments in India. QFI to directly open an account with a Qualified Depository Participant (QDP) in India.	No direct registration with SEBI. Instead, DDP authorised by SEBI would register FPIs on behalf of SEBI subject to compliance with the KYC requirements.
KYC (know your client) Norms	
Uniform KYC norms apply to all the investors.	In the new regime, SEBI has moved towards a risk-based approach to KYC, where government-related FPIs (Category I FPIs) would be subject to less stringent KYC norms, all regulated entities (Category II FPIs) would be subject to moderate KYC norms and unregulated investors (Category III FPIs) would have to undergo stringent KYC norms.
Broad Based Criteria	
Under the FII Regulations, a 'broad-based fund' meant a fund, established or incorporated outside India which has at least 20 investors with no investor holding more than 49% of the shares or units of the fund. Where the broad-based fund had any institutional investor, it was ***not*** necessary for such fund to have 20 investors. Further, any institutional investor holding more than 49% of the shares or units of the fund would have to itself satisfy the broad based criteria.	The FPI Regulations continue to follow the 'broad-based' criteria with two notable deviations. • To satisfy the 'broad-based' criteria, it *would be necessary* for a fund to have 20 investors even if there is an institutional investor. • To compute the number of investors in a fund, both direct and underlying investors, *i.e.* investors of entities that are set up for the sole purpose of pooling funds and making investments, shall be counted.
Investment In Unlisted Securities	
The FIIs can make investment in unlisted securities in India.	Investments in unlisted securities, regardless of the level of ownership that they represent, regarded as FDI.
Investment Limits	
The FIIs shareholding was *not to exceed* 10 % of the share capital. Aggregate shareholding of all FIIs shall not exceed the lower of (i) 24% of the paid up equity capital of the company at any point of time or (ii) the sectoral cap. QFIs – 5% (individual) and 10% (aggregate) of the paid- up capital of the Indian company. The QFI limits were over and above the limits specified in the case of FIIs.	A single FPI or an investor group shall purchase *below* 10% of the total issued capital of a company or 10% of the paid-up value of each series of convertible debentures issued by an Indian company. The total holdings of all FPI put together shall not exceed 24 % of paid-up equity capital or paid-up value of each series of convertible debentures.

FII / QFI Regime	FPI Regime
	Where the *same set* of ultimate beneficial owner(s) invests through multiple FPI entities, such FPI entities shall be treated as part of the same investor group. Further, the investment limits of all such entities shall be clubbed at the investment limit as applicable to a single FPI.
Monitoring of Investment Limits	
Monitoring of the above investment limits was done at an *investor group level* after considering who the ultimate beneficial owner is or who holds the ultimate beneficial interest in the investing entity/ies. The identity of the ultimate beneficial owner in an entity who owns more than 50 % of the total capital of that entity (called the 'ownership test') was followed for FIIs.	The FPI Regulations have sought to replicate this practice. However, in the FPI Regulations, SEBI has stipulated that the monitoring of this limit needs to be done based on: (1) the shareholding, (2) the voting rights, and (3) any other form of control that may exist in excess of 50 % across the FPIs, if any.
Issue of Offshore Derivative Instruments (ODIs)	
FIIs are eligible to issue ODIs based on the shares held by them. Sub-accounts are not eligible to issue ODIs. QFIs are not eligible to ODIs.	(1) Category-III FPIs barred from issuing ODIs. The FPI Regulations bars even those unregulated broad-based funds that are classified as Category-II FPIs by virtue of their investment manager being appropriately regulated (which, under the FII Regulations, were eligible to hold ODIs). (2) Entities that qualify as regulated broad based sub accounts, may also issue ODIs under the FPI Regulations (which, under the FII Regulations, could not do so as 'broad based sub-accounts').

With the introduction of the FPI Regulations, QFIs will now be able to invest in additional securities like Rupee-denominated bonds/units of IDFs, IDRs, SRs issued by ARCs, *etc*. Moreover, under the current regulations, a single QFI was allowed to invest in an Indian-listed company, a maximum of up to 5 % of the total paid-up capital of the company; this limit would now double, as an FPI can invest a maximum of 10 % of the total paid-up capital of an Indian-listed company.

4. Tax Framework

Presently, a differential tax treatment is prevailing for FIIs and QFIs. The Income-tax Act, 1961 (the Act) contains specific provisions for taxation of FIIs/Sub-Accounts. Section 115AD of the Act provides a concessional basis of taxation to FIIs/ sub-accounts in terms of:

(i) taxing the income earned by them from sale of Indian securities as capital gains,

(ii) prescribing concessional tax rates for this type of investor, and

(iii) exempting them from withholding the tax requirements on their capital gains income – Section 196D of the Act.

There is no specific code for taxation of QFIs. Kindly see the next page for the snapshot of the tax rates applicable to the FPIs and its comparison with the FII and QFI tax rates.

Following are some of the tax ambiguities which continue to remain and need to be addressed in order to provide clarity and certainty to foreign portfolio investors:

i) FPIs are covered under the Section 115AD of the Act by way of a CBDT notification. In order to rule out any controversy and litigation in the matter, it is suggested that the Act be amended.

ii) FPI Regulations have come into force from 7th January, 2014, however, the CBDT notified on 22nd January, 2014, the applicability of Section 115AD to FPI investors. Hence, FPI investors who would have put their arrangements in place with a bona fide belief that such

arrangements were within the framework of a new regime would be put to difficulty. Hence, suitable transitional/grandfathering provisions should be incorporated in the Income-tax Act, 1961 which would avoid such difficulties to taxpayers.

iii) Direct Tax Code proposal to deem income of FIIs as income from capital gains should be brought in the statute to make the matter beyond any doubt for the FPI investors.

Until the tax and regulatory regimes are aligned to make India an attractive jurisdiction for foreign investments, investors may continue to be weary of making investments in India.

5. Conclusion

Today, foreign investors face an ad hoc system of sometimes overlapping, sometimes contradictory and sometimes non-existent rules for different categories of players resulting in the lack of transparency and create onerous transaction costs. Adding to these complexities is the complicated tax structure resulting in uncertainty in the tax policy for such investments. All these impediments not only result into higher transaction costs to foreign investors but also translate into higher cost of capital for Indian companies who are accessing foreign equity capital.

By integrating the existing portfolio routes available for foreign investors and providing clarity on the tax policy, the Government has done well to remove some of the impediments for portfolio investors. However, in line with the revamping of the regulatory framework for foreign portfolio investments, the GOI should also consider revamping the tax policies and tax laws so as to place an integrated regulatory and tax framework to make it more conducive for foreign investments. ■

Assessment Year: 2014-2015 (Previous Year: 1st April, 2013 to 31st March, 2014)	*(all numbers are in percentages)*					
Nature of Income	Rate of tax[7]					
	FIIs/Sub-Accounts		**QFIs**		**FPIs (including QFIs)**	
	Foreign Companies	Non-corporate entities	Foreign Companies	Non-corporate entities	Foreign Companies	Non-corporate entities
Dividend						
Dividends/income in respect of units of a Mutual Fund	Nil	Nil	Nil	Nil	Nil	Nil
Interest						
Interest under Section 194LD[8] of the Act	5	5	5	5	5	5
Interest other than interest under Section 194LD of the Act	20	20	40	30	20	20
Capital Gains						
Capital Gains on sale of shares and units of equity oriented funds subject to STT						
Long-term capital gains	Nil	Nil	Nil	Nil	Nil	Nil
Short-term capital gains	15	15	15	15	15	15
Capital Gains on sale of bonds, debentures, off-market equity transactions not subject to STT						
Long-term capital gains	10	10	20[9]/10	20/10	10	10
Short-term capital gains	30	30	40	30	30	30
Other Income	40	30	40	30	40	30

[7] *Tax rates are exclusive of Surcharge and Education Cess: For foreign company surcharge is applicable at the rate of 2% if taxable income exceeds INR 10 million but does not exceed INR 100 million and at the rate of 5% if taxable income exceeds INR 100 million. For non-corporate assessees surcharge is applicable at the rate of 10% if taxable income exceeds INR 10 million. Education cess at the rate of 3% of Income-tax and surcharge is applicable to all taxpayers.*

[8] *The above rates are not applicable where a lower rate is prescribed under a DTAA entered into by the Central Government under Section 90 of the Act. Section 194LD of the Act provides for a concessional rate of withholding tax of 5% (to be increased by applicable surcharge and education cess) in case of income earned by FIIs or QFIs in the nature of interest from a Rupee denominated bond of an Indian company or a Government security. The interest should be payable between 1st June 2013 to 31st May 2015. Further, the rate of interest in respect of the bond of an Indian company should not exceed the rate as notified by the Central Government.*

[9] *Subject to indexation benefits under the Act.*