Funds Hotline

June 19, 2013

SEBI TO DECIDE ON THE K.M CHANDRASEKHAR COMMITTEE REPORT ON SIMPLIFYING THE FOREIGN PORTFOLIO INVESTMENT REGIME

In a move to encourage and simplify foreign portfolio investment regimes, the Securities and Exchanges Board of India ("**SEBI**"), in line with the announcement by the Finance Minister in his Budget 2013 speech[1], has released the list of major recommendations of the Committee on Rationalisation of Investment Routes and Monitoring of Foreign Portfolio Investments ("**Committee**"). The Committee was constituted to study the convergence of the various portfolio investment regimes. While the complete report submitted by the Committee ("**Committee Report**") is yet to be disclosed, the key recommendations of the Committee have been announced vide a press release by the SEBI.[2] We thought it fit to apprise you of the development and analyze some of these recommendations to the extent they have been released. SEBI will take a decision on the recommendations of the Committee in its next Board meeting on June 25, 2013. Our analysis on the Committee Report will follow.

BACKGROUND

The Board of the SEBI had, in its meeting held on October 6, 2012, decided to harmonize/rationalize, and thereby, ease the entry routes for various foreign portfolio investors into India. The aim was to prepare a uniform guideline for various categories of investors such as Foreign Institutional Investors ("**FIIs**"), Foreign Venture Capital Investors ("**FVCIs**"), Non Resident Indians ("**NRIs**"), Qualified Foreign Investors ("**QFIs**"), etc. based on the guidance of the Working Group on Foreign Investment in India, i.e., the U.K. Sinha Committee.

To implement this decision, the Committee was formed under the Chairmanship of K.M Chandrasekhar and consisted of representatives from the Government of India ("**GoI**"), the Reserve Bank of India ("**RBI**") and various market participants.

MAJOR RECOMMENDATIONS

1. A new investor class, "Foreign Portfolio Investor" ("**FPI**"), to replace FIIs and QFIs. Existing FIIs, their sub accounts and QFIs to be merged into FPIs.
2. NRIs and FVCIs to be retained as classes of investors for the present with no change in investment limits prescribed for NRIs. However, the limit of nine sectors for the FVCIs to be expanded or replaced by a negative list to be announced by GoI.
3. The aggregate investment limit of FPIs to be 24% (being the present default aggregate limit for FIIs, which can be raised by the company up to the sectoral cap).
4. Portfolio investments to be defined as investment by any single investor or investor group, which shall not exceed 10% of the equity of an Indian company. Any investment beyond the threshold of 10% to be considered as FDI.
5. Prior direct registration of FIIs and sub accounts with SEBI to be done away with and instead, FPIs to register themselves with and transact through Designated Depository Participants ("**DDPs**").
6. Know Your Client ("**KYC**") checks to be based on risk categorization of FPIs, with documents needed for registration and onboarding being the simplest for Category I and the most stringent for Category III:
   - Government and Government-related entities such as Foreign Central Banks, Sovereign Wealth Funds, Multilateral Organizations, etc. to be classified as Category I (Low Risk) FPIs;
   - Regulated entities such as Banks, Asset Management Companies, Broad Based Funds such as Mutual Funds, Investment Trusts, Insurance and Reinsurance Companies, University Funds, Pension Funds and University related Endowments already registered with SEBI to be classified as Category II (Moderate Risk) FPIs.
   - All other FPIs not eligible to be included in the above two Categories to be classified as Category III (High Risk) FPIs.

   Requirement of submitting personal identification documents such as copy of passport, photograph etc. of the designated officials of FPIs belonging to Category I and Category II to be done away with. SEBI to separately prescribe the documentation needed for the 3 Categories.
7. FPIs belonging to the Category III to be not allowed to issue Offshore Derivative Instruments ("**ODI**")/Participatory Notes ("**PN**").

ANALYSIS

While it may be too soon to comment on the recommendations, especially in the absence of access to the complete

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Committee Report, a preliminary analysis of the press release yields the following takeaways.

1. With the investment limits of FPIs being capped at 24% and QFIs being merged into FPIs, the existing foreign investors classified as QFIs would be entitled to the benefit of higher investment limits from the current prescribed limits of 5% (individually) and 10% (in aggregate).

2. The report of the U.K. Sinha Committee ("**UKS Report**") had suggested that all classes of portfolio investments, namely, FIIs, sub accounts, FVCIs and NRIs be abolished as investor classes and be merged into the then-proposed 'qualified foreign investor' or QFI regime. Nishith Desai Associates had suggested to SEBI on the UKS Report to treat the FVCI regime differently from portfolio investment. The Committee seems to have taken cognizance of the industry demands and has recommended the retention of the NRI and FVCI classes. The retention of the FVCI regime also manifests the recognition of FVCIs as growth partners. Not only has the route been retained, the Committee has recommended expanding the sectors in which FVCIs are permitted to invest in.

3. The Committee's recommendation is that prior direct registration of FIIs and sub-accounts with SEBI be done away with and that FPIs be able to register themselves with and transact through DDPs. Not only will this ease the process of entry and investment for foreign portfolio investors and reduce the timeline involved in initiating investments by portfolio investors, it will also lead to a disintermediated platform, wherein FIIs would earlier be treated as intermediaries for investments by virtue of their registrations with SEBI. This recommendation also appears to be in line with that of the UKS Report.

4. The introduction of the definition of 'portfolio investments' and its basis being on the extent of shareholding, rather than class of investors or investment in listed securities, is a move in line with UKS Report. The Committee has also referred to the concept of 'investor group' in the context of portfolio investments which has not been defined. It remains to be seen whether the Ultimate Beneficial Ownership test under the present QFI regime will be the benchmark for 'investor group' or not, but the intent seems to prevent an FPI investor from taking indirect benefit of larger shareholding without being qualified as FDI.

   We understand that the 10% threshold for classification as 'portfolio investments' may be based on the same reasoning provided under the UKS Report i.e., it is the standard OECD distinction and practice as well of peer countries such as Brazil, South Korea, South Africa and Turkey which have comparably sized domestic markets and democratic governance.[3]

5. It would be of interest to see the situations where portfolio investments exceed 10% at some time and become FDI. On an attendant note, how investments made as FDI falling below 10% would be treated as, if such investments have extended degree of control, will have to be examined. The Committee has apparently discussed this and the thought process on such transitions will be detailed in the Committee Report.

6. The Committee has adopted a risk based approach and has segregated FPIs into 3 Categories allocating its risk assessment with each such Category. We may, however, need to understand further as to the investment entities that would be included in Category III. Category III FPIs, akin to current QFIs and sub accounts, will not be allowed to issue participatory notes, which is largely in line with the extant regime.

7. The press release does not make a mention of the responsibilities of DDPs to withhold tax under the FPI regime. This may be relevant for greater clarity in the roles of the DDPs. Under the QFI regime, Qualified Depository Participants ("**QDPs**") were assigned the responsibility to act as a single point of contact for all purposes including withholding tax. QDPs would be responsible for any withholding tax in India before remitting returns to QFIs. However, under the present FII regime, FIIs themselves were responsible for all tax obligations on all remittances made.

CONCLUSION

The recommendations of the Committee seem to be a positive move towards simplifying the foreign investment norms in India. However, the devil is in the detail. Such a broad change of regulations with respect to foreign investment into India would need to be done with utmost care. At a time when the country needs further foreign investments to meet its fiscal deficit, changes should be carried out with minimum disruption to the market and taking into account the views of the all participants in the market, most importantly the foreign investors. While the move to rationalize the KYC requirement to a risk based model will be welcomed by all, other changes will be keenly watched by all participants. Key questions that arise will be whether distinction of investment in listed/unlisted securities for FII/FDI investors has been done away with, since currently FII investors are not allowed to purchase unlisted securities and FDI investors are not allowed to purchase listed securities on the floor of the exchange; whether QDPs will be allowed to merely transfer their QDP license for a DDP license or will have to apply fresh; the grace period that SEBI will allow for transition of the regime; recognition of existing KYCs of clients of FIIs for the new regime etc. This list is based merely on the press release. The release of the Committee Report and SEBI's adoption of the Committee Report and the ensuing regulation may raise its own list of questions that will need to be debated, discussed and addressed for a successful transition. We look forward to the release of the Committee Report.

- Nikhil Joseph, Akshay Bhargav, Ruchir Sinha & Pratibha Jain
You can direct your queries or comments to the authors

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[1] The full text of the Budget 2013-2014 speech can be accessed here
[2] The press release by SEBI can be accessed here
[3] UKS Report, http://finmin.nic.in/reports/WGFI.pdf, pages 77 to 81

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based on the specific facts and circumstances. This Hotline does not substitute the need to refer to the original pronouncements.

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