Funds Hotline

January 20, 2014

FOREIGN PORTFOLIO INVESTORS REGULATIONS NOTIFIED – SIGNIFICANT DEPARTURE FROM THE EXISTING FOREIGN INSTITUTIONAL INVESTORS REGIME

- Foreign Portfolio Investors (FPI) Regulations notified, repeals FII Regulations.
- FPIs differentiated into categories based on risk-based KYC norms.
- Changes made to broad-based criteria and eligibility to issue and hold ODIs.
- Rules concerning taxation of FPIs yet to be formalized; anticipated to be largely in line with tax framework for FIIs.
- Designated Depositary Participants (DDPs) authorized to process applications on behalf of SEBI.

The recently notified Securities and Exchange Board of India (Foreign Portfolio Investors) Regulations, 2014 ("**FPI Regulations**"), which repeals the SEBI (FII) Regulations, 1995 ("**FII Regulations**"), significantly revises the regulation of foreign portfolio investments into India.

FPI Regulations seek to introduce a risk-based approach towards investor Know Your Customer (KYC) requirements, ease the entry process and reduce timelines for investor participants. However, on the key issues which foreign investors currently deal with, *viz.* ambiguity on the 'broad based' criteria, eligibility to issue/subscribe to offshore derivative instruments and clubbing of investment limit, SEBI seems to have revisited the current position which may impact the industry. Interestingly, SEBI also seems to have changed the individual investment cap that an FPI can hold in Indian companies under the FPI Regulations.

FPI: AN INTRODUCTION

Under the FPI regime, Securities and Exchange Board of India ("**SEBI**") has harmonized foreign institutional investors ("**FIIs**"), sub-accounts and qualified foreign investors ("**QFIs**") regimes into a single investor class – foreign portfolio investors ("**FPI**") and provide a single window clearance through designated depository participants ("**DDPs**"). With each investor registering directly as an FPI (under the respective three categories discussed later), the *sponsored sub accounts* structure seems to be over.

The FPI Regulations put into effect several recommendations made by the *Committee on Rationalisation of Investment Routes and Monitoring of Foreign Portfolio Investments* chaired by Mr. K.M. Chandrasekhar in 2013.

From the point of view of KYC, the committee recommended (and the FPI Regulations provide) for following categorization of FPIs based on their perceived risk profile:

Eligible Foreign Portfolio Investors	Category I FPI	Category II FPI	Category III FPI
	Government and Government-related investors such as central banks, Governmental agencies, sovereign wealth funds or international and multilateral organizations or agencies	(i) Appropriately regulated broad based funds[1]; (ii) Appropriately regulated persons[2]; (iii) Broad-based funds that are not appropriately regulated[3]; (iv) University funds and pension funds; and (v) University related endowments already registered with SEBI as FIIs or sub-accounts	Includes all eligible FPIs who are not eligible under Category I and II, such as endowments, charitable societies, charitable trusts, foundations, corporate bodies, trusts, individuals and family offices.

The FPI categorization follow the risk based KYC regime as set out in SEBI's circular dated September 12, 2013[4] for foreign investors investing under portfolio investment scheme.

CHANGES IN THE 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. It was also provided that if 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.

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The FPI Regulations continue to follow the broad-based criteria with two notable deviations. One, in order to satisfy the broad-based criteria, it would be necessary for a fund to have 20 investors even if there is an institutional investor. Two, for the purpose of computing 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.

'NEW' INVESTMENT LIMITS

Regulation 21(7) of the FPI Regulations states that a single FPI or an investor group shall purchase *below* ten percent of the total issued capital of a company. The position under the FII Regulations was that such shareholding was *not to exceed* ten percent of the share capital. Effectively, a single FPI can now hold up to 9.99% of the share capital of an Indian company.

The FPI Regulations provide that in case 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[5] and the investment limits of all such entities shall be clubbed at the investment limit as applicable to a single FPI.

NEW RULES FOR HOLDING ODI[6]

Regulation 22 of the FPI Regulations provides that Category I FPIs and Category II FPIs (which are directly regulated by an appropriate foreign regulatory authority[7]) are permitted to issue, subscribe and otherwise deal in offshore derivative instruments ("**ODIs**"). However, those Category II FPIs which are not directly regulated (which are classified as Category-II FPI by virtue of their investment manager being appropriately regulated) and all Category III FPIs are not permitted to issue, subscribe or deal in ODIs.

As compared to the FII regime, two differences emerge, (1) Broad based 'unregulated' funds are not eligible to subscribe to ODIs, even if they are managed by appropriately regulated person (which, under the FII Regulations, were eligible to hold ODIs) and, (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').

These are critical set of changes for FIIs that issue ODIs. The class of eligible entities issuing ODIs has been expanded (bringing more potential players who have the requisite balance sheet to issue such instruments, in the fray). Further, the FPI Regulations also remove unregulated funds as potential holders of ODIs (as the regulator seems to encourage the format of direct participation for such investors). Additionally, there is still no clarity on which entities would qualify as being regulated by an "appropriate foreign regulatory authority" and to whom ODIs can be issued under the FPI Regulations.

Whether offshore derivative instruments (ODIs) can be issued or otherwise dealt with?	**Category I FPI**	**Category II FPI**	**Category III FPI**
	Yes	Yes. (However, unregulated broad-based funds which are classified as Category-II by virtue of their investment manager being appropriately regulated, are not permitted to issue, subscribe or otherwise deal in ODIs)	No.

PCC/SPC: NOW WELCOMED

Prior to December, 2013, there was a blanket ban on protected cell companies ("**PCCs**"), segregated portfolio companies ("**SPCs**") or equivalent structures which used to ring-fence assets and liabilities under law) from participating under the FII route.

Based on the representations made by our firm, SEBI recently provided that entities that apply for registration under the FII Regulations shall not be regarded as having an opaque structure if they are required by their regulator or under any law to ring fence their assets and liabilities from other funds / sub-funds in the entity. This applied for structures such as open-ended investment companies (OEICs) in the UK. OEICs are typically set up in the format of umbrella companies that have several 'sub-funds'. Recent amendments to the OEIC regulations in the UK required that a PCC structure be adopted to ring fence liabilities between these sub-funds.

The position has evolved further under FPI Regulations and, as long as (a) the applicant is regulated in its home jurisdiction, (b) each fund / sub-fund in the applicant satisfies the broad-based criteria, and (c) the applicant undertakes to provide information regarding its beneficial owners upon SEBI's request, the applicant shall not be regarded as having an 'opaque structure'.

NEXT STEPS FOR THE REGIME ROLL OVER

SEBI has to be lauded for its effort to harmonize the different foreign portfolio investment routes under the umbrella FPI regime. With the delegation of responsibilities to DDPs, the regime roll over will have to be carefully 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.

Clarity is still lacking on certain key issues such as the rollover process from the FII regime to the FPI regime (particularly from a registration standpoint) as well as on tax implications, as the FPI Regulations in their current form do not contain any language to suggest that all categories of FPIs would be treated as FIIs for the purpose of the Income Tax Act, 1961 ("**Tax Act**") and no circulars have yet been issued by Central Board of Direct taxes (CBDT).

Thus, while SEBI has notified the FPI Regulations, repealing the FII Regulations, the FPI regime would become fully operational only once suitable amendments have been made to the Tax Act and the Foreign Exchange Management Act, 1999 ("**FEMA**"). Consequently, the FPI Regulations[8] provide that SEBI will continue to process applications under the old regime till March 31, 2014 since SEBI appears to be of the view that required amendments to the Tax Act and the FEMA will take place by such date.

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You can direct your queries or comments to the authors

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[1] Includes mutual funds, investment trusts, insurance/reinsurance companies

[2] Includes banks, asset management companies, investment managers/advisors, portfolio managers

[3] This is subject to the fact that the investment manager of such broad based fund is regulated and undertakes that it will be responsible for the acts, omissions and other things done by the underlying broad-based funds.

[4] CIR/MIRSD/ 07 /2013

[5] As per the Operational Guidelines for Designated Depository Participants ("**Operational Guidelines**") released by SEBI, for the purpose of ascertaining investor group, the concerned DDPs shall consider all such entities having direct or indirect common shareholding / beneficial ownership / beneficial interest of more than 50% as belonging to same investor group.

[6] ODIs have been defined as "any instrument, by whatever name called, which is issued overseas by a FII against securities held by it that are listed or proposed to be listed on any recognized stock exchange in India, as its underlying."

[7] Reference may be made to Explanation 1 to Regulation 5 of the FPI Regulations where it is provided that an applicant (seeking FPI registration) shall be considered to be "appropriately regulated" if it is regulated by the securities market regulator or the banking regulator of the concerned jurisdiction in the same capacity in which it proposes to make investments in India.

[8] Regulation 47(3)(c) of the FPI Regulations.

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