Executive summary

The Securities and Exchange Board of India (SEBI) has recently notified the SEBI (Foreign Portfolio Investors) Regulations, 2014 (FPI Regulations). These Regulations shall come into force with effect from 7 January 2014.

Further, the SEBI has also vide a Circular dated 8 January 2013 (Circular) issued operating guidelines for Designated Depository Participants who would grant registration to Foreign Portfolio Investors.

The FPI Regulations aim to rationalize foreign investments made into India by portfolio investors such as Foreign Institutional Investors and Qualified Foreign Investors. This alert summarizes the key features of the FPI Regulations and the Circular.

[1] Notification No. LAD-NRO/GN/2013-14/36/12 dated 7 January 2014
The Securities and Exchange Board of India (SEBI) had formed a ‘Committee on Rationalization of Investment Routes and Monitoring of Foreign Portfolio Investments’ (Committee), under the Chairmanship of Shri K.M. Chandrashekar, with a view to rationalise foreign portfolio investments made by Foreign Institutional Investors (FIIs), Non Resident Indians (NRIs) and other foreign investors.

A report was submitted by the Committee on 12 June 2013 to the SEBI. After considering the recommendations of the Committee, SEBI issued a press release dated 5 October 2013 indicating the salient features of the draft SEBI (Foreign Portfolio Investors) Regulations, 2013.

On 7 January 2014, the SEBI notified the SEBI (Foreign Portfolio Investors) Regulations, 2014 (FPI Regulations). The same shall be effective with effect from 7 January 2014.

Subsequently, the SEBI has also vide a Circular dated 8 January 2013 (Circular) issued operating guidelines for Designated Depository Participants (DDP) who would grant registration to Foreign Portfolio Investors (FPI).

With the notification of the FPI Regulations, the SEBI (FII) Regulations, 1995 (FII Regulations) stand repealed. However, the SEBI may continue to grant certificate of registration (COR) to FII/sub-accounts under the FII Regulations till 31 March 2014 which may be extended up to 30 June 2014.

SEBI has also rescinded various Circulars issued in connection with investments by Qualified Foreign Investors (QFIs) in mutual fund schemes, equity shares and Indian corporate debt instruments etc.

This alert highlights the key features of the FPI Regulations and the Circular applicable to FPIs and DDPs.

FPI Regulations at a glance

- DDPs (and not SEBI) to grant registration to FPIs.
- Registration as a FPI can be obtained in one of the three categories specified by SEBI.
- Registration granted to a FPI shall be permanent unless suspended or cancelled by SEBI or surrendered by the FPI.
- Existing FII or QFI shall be deemed to be a FPI till expiry of three years for which fees have been paid under the FII Regulations.
- An existing FII is permitted to transact in securities till the expiry of its registration as a FII. Post expiry of registration (or earlier), it can obtain a COR as a FPI by payment of conversion fees.
- Existing QFIs to obtain a COR as a FPI within one year from 7 January 2014.
- Investment in equity shares of a company by a single FPI or investor group to be below 10% of the issued capital of the company.
- 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.
- Presently, a differential tax treatment is prevailing for FII and QFI. However, as per the press release issued by SEBI of its board meeting on 24 December 2013, the Department of Economic Affairs has communicated to the Central Board of Direct Taxes and SEBI that all three categories of FPIs may be given similar tax treatment as available to FII presently.

Please refer our alert dated 20 June 2013 summarizing the major recommendations of the Committee.
Please refer our alert dated 9 October 2013 summarizing the salient features of the Press Release dated 5 October 2013.
Foreign Portfolio Investor

Meaning of FPI

- The term ‘FPI’ has been defined to mean a person who satisfies the eligibility criteria prescribed under the FPI Regulations and has been registered under these Regulations.

- No person shall transact in securities as a FPI unless it has obtained a COR granted by the DDP on behalf of SEBI.

- An existing FII holding a valid COR shall be deemed to be a FPI till the expiry of the block of three years for which fees have been paid under the FII Regulations.

Categories of FPI

An applicant can seek registration as a FPI in any one of the following categories:

- Category I – This category shall include Government and Government related entities such as Central Banks, Governmental agencies, sovereign wealth funds and international or multilateral organizations or agencies.

- Category II – This category shall include:
  - ‘Appropriately regulated’ broad based funds such as Mutual Funds, Investment trusts, Insurance/ Reinsurance Companies;
  - Appropriately regulated entities such as Banks, Asset Management Companies etc.;
  - Broad based funds not appropriately regulated but whose investment manager is regulated6;
  - University Funds and Pension Funds; and
  - University related endowments already registered with the SEBI as FIIIs/ sub-accounts.

- Category III - This category shall include all other FPIs not eligible to be included in the above two Categories such as endowments, charitable societies, charitable trusts, foundations, corporate bodies, trusts, individuals and family offices.

- Any other category as may be specified by the SEBI from time to time.

Registration requirements and eligibility criteria for a FPI

- DDPs are authorised to grant registration to FPIs on behalf of the SEBI. The application for grant of registration is to be made to the DDP in a prescribed form alongwith the specified fees.

- The eligibility criteria for a FPI, inter-alia, includes:
  - The applicant is a person not resident in India7.
  - The applicant is resident of a country whose securities market regulator is a signatory to International Organization of Securities Commission's Multilateral Memorandum of Understanding or a signatory to bilateral Memorandum of Understanding with the SEBI.
  - The applicant is not residing in a jurisdiction identified by the Financial investors in a fund, direct investors as well as underlying investors shall be considered.

Footnotes:

4 ‘Appropriately regulated’ means an applicant which is regulated or supervised by the securities market regulator or the banking regulator of the concerned foreign jurisdiction.

5 ‘Broad based fund’ means a fund, established or incorporated outside India with at least 20 investors, with no investor holding more than 49% of the shares or units of the fund. For ascertaining the number of

6 The investment manager is required to be registered as a category II FPI and provide an undertaking of it being responsible for all acts of the broad based fund.

7 The terms ‘person’, ‘non-resident’ and ‘resident’ shall have the meanings assigned under the Income-tax Act, 1961.
Action Task Force (FATF):

► as having strategic Anti-Money Laundering or Combating the Financing of Terrorism deficiencies; or
► as not having made significant progress in addressing the deficiencies or not committed to an action plan developed with the FATF to address the deficiencies.

► The applicant being a bank, is a resident of a country whose Central bank is a member of Bank for International Settlements.

► The applicant is not a non-resident Indian.

► The applicant is a fit and proper person as per the SEBI (Intermediaries) Regulations, 2008.

Registration requirements for existing FIIs and QFIs

► FIIs/ sub-accounts may, subject to payment of conversion fees, continue to trade in securities till the expiry of its registration or obtaining of a COR, whichever is earlier.

► QFIs would be required to obtain a COR as a FPI within one year from 7 January 2014 (i.e. the date of commencement of the FPI Regulations).

Investment conditions and restrictions

► A FPI shall be permitted to invest only in the following securities:

► Securities in the primary and secondary markets;
► Units of schemes floated by domestic mutual funds, collective investment schemes;
► Derivatives traded on a recognized stock exchange;
► Treasury bills and dated government securities;
► Commercial papers issued by an Indian company;
► Rupee denominated credit enhanced bonds;
► Security receipts issued by asset reconstruction companies;
► Perpetual debt instruments and debt capital instruments;
► Listed and unlisted non-convertible debentures (NCDs)/ bonds issued by an Indian company in the infrastructure sector;

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8 In case of an applicant being a bank or its subsidiary, the DDP is required to forward the details of the applicant to SEBI who would in turn request the Reserve Bank of India to provide its comments. The comments of the Reserve Bank of India would be provided by the SEBI to the DDP.

9 One of the conditions include that the applicant is an India dedicated fund or undertakes to make investment of atleast 5% corpus of the fund in India.

10 Including shares, debentures and warrants of companies, listed or to be listed on a recognized stock exchange in India.

11 Listed and unlisted.

12 Infrastructure sector is defined to, inter-alia, include, (i) energy, (ii) communication, (iii) transport, (iv) water and sanitation (v) mining, exploration and refining and (ix) Social and commercial infrastructure.
NCDs/ bonds issued by Non-Banking Financial Companies categorized as ‘Infrastructure Finance Companies’;
- Rupee denominated bonds/ units issued by infrastructure debt funds;
- Indian depository receipts; and
- Other specified instruments.

Existing FIIs/ sub account holding unlisted equity shares in a company and continuing to hold such shares after an initial public offering and listing thereof, shall be subject to lock-in for the same period, if any, as is applicable to shares held by a foreign direct investor.

Additional conditions have been prescribed in the FPI Regulations in respect of investments made in the secondary market. The same, inter-alia, include:

- Transactions permitted only on the basis of taking/ giving delivery of securities (except for transactions in derivatives; short selling transactions, etc);
- No transactions on the stock exchange shall be carried forward.
- Transactions in securities to be undertaken only through registered stock brokers (except for transactions in Government securities, open offers, buy-backs and other prescribed transactions).
- Investment in equity shares of a company by a single FPI or investor group13 shall be below 10% of the issued capital of the company.

Where the same set of ultimate beneficial owner(s) invest through multiple entities, such 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 FPI.

FPIs are allowed to lend or borrow securities.

Issuance of offshore derivative instrument (ODI)

FPIs may issue, subscribe or deal in ODIs14 subject to the following conditions:

- ODIs are issued to persons regulated by an appropriate foreign regulatory authority; and
- ODIs are issued by complying with Know Your Customer norms.

Unregulated broad based funds (categorised as Category II FPIs by virtue their investment manager being appropriately regulated) are not permitted to issue, subscribe or deal in ODIs such as participatory notes, directly or indirectly.

Category III FPIs are not permitted to issue, subscribe or deal in ODIs, directly or indirectly.

A FPI shall ensure that further issue or transfer of any ODI (issued by or on behalf of it) is only made to persons regulated by an appropriate foreign regulatory authority.

FPIs shall fully disclose to SEBI the terms of and parties to ODIs entered into by it, as and when and in such form as SEBI may specify.

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13 To ascertain an investor group, the DDPs shall consider all entities having direct or indirect common shareholding/ beneficial ownership/ beneficial interest of more than 50% as belonging to the same investor group.

14 ODI means any instrument issued overseas by a FPI against securities held by it that are listed or proposed to be listed on any recognised stock exchange in India, as its underlying.
Obligations and responsibilities of FPI

The obligations and responsibilities of FPI, inter-alia, include:

► FPIs to obtain a Permanent Account Number (i.e. Indian income-tax registration number) from the Indian Revenue authorities.

► FPI to appoint a compliance officer who shall be responsible for monitoring the compliance of various rules, regulations, notifications, etc issued by the DDP or SEBI or the Central Government.

► A FPI (or any of its employees) shall not render directly or indirectly any investment advice about any security in the publicly accessible media, unless a disclosure of his interest including long or short position in the said security has been made, while rendering such advice.

An employee rendering such an advice is also required to disclose the interest of his dependent family members and his employer.

Fees payable by FPIs

Conversion Fees

► Existing FII/ sub-accounts shall be required to pay conversion fees of US$ 1,000 to SEBI on or before the expiry of its registration.

No fee is payable by the applicant, which is an international/ multilateral agency\(^\text{15}\) such as World Bank and other institutions.

Registration Fees

► No registration fee to be paid by Category I FPIs.

► Where various Category I FPIs have common beneficial owners, only one FPI is exempt from payment of fee under Category I and other FPIs are required to pay registration fees as applicable to Category II (except where the beneficial owner is international/ multilateral agency such as World Bank and other institutions).

► Category II and Category III FPIs to pay registration fees of US$ 3,000 and US$ 300, respectively for every block of three years.

Designated Depository Participant

Application for approval

► A person can act as a DDP only after obtaining an approval of SEBI.

However, an existing registered custodian of securities and qualified depository participant shall be deemed to have been granted approval as a DDP subject to the payment of prescribed fees.

► An application for approval to act as a DDP shall be made to SEBI through the depository in which the applicant is a participant accompanied by the prescribed fees.

Eligibility criteria for DDP

SEBI shall grant an approval to a person to act as DDP subject to satisfaction of, inter-alia, the following conditions:

► The applicant is a participant and custodian registered with the SEBI;

\(^{15}\) Established outside India for providing aid and which have been granted privileges and immunities from payment of tax and duties by the Central Government.
The applicant is an Authorized Dealer Category-1 bank authorized by the Reserve Bank of India;

The applicant has multinational presence either through its branches or through agency relationships with intermediaries regulated in their respective home jurisdictions;

The applicant has systems and procedures to comply with the requirements of FATF Standards, Prevention of Money Laundering Act, 2002, and the rules and circulars prescribed thereunder.

A COR granted to a DDP shall be permanent unless suspended or cancelled by SEBI or surrendered by the DDP.

A DDP (or any of its employees) shall not render directly or indirectly any investment advice about any security in the publicly accessible media, unless a disclosure of his interest including long or short position in the said security has been made, while rendering such advice.

An employee rendering such an advice is also required to disclose the interest of his dependent family members and his employer.

**Comments**

Driven by the rationale of having an integrated policy on foreign investments, the market regulator, SEBI, has notified the FPI Regulations. The FPI Regulations have been introduced to make the Indian market a more attractive investment destination and include easier entry norms and operational framework for the foreign entities.

The FPI regime provides for a unified regulatory framework for erstwhile FII and QFI investors.

Further, currently, the tax rules applicable to FIIs/ sub-accounts and QFIs differ. However, as per the press release issued by SEBI of its board meeting on 24 December 2013, the Department of Economic Affairs has communicated to the Central Board of Direct Taxes and SEBI that all three categories of FPIs may be given similar tax treatment as available to FIIs presently.

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16 ‘Opaque structure’ shall mean structures such as protected cell company, segregated cell company or equivalent, where the details of the ultimate beneficial owners are not accessible or where the beneficial owners are ring fenced from each other or where the beneficial owners are ring fenced with regard to enforcement.
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