Paper 18

Foreign Institutional Investment in India©

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- Who is a Foreign Institutional Investor
- Registration with the SEBI
- Criteria
- Fees
- Sub-accounts
- Bank account and custodian
- Preferential allotment by listed Indian Companies to FIIs
- Proprietary funds
- Forward cover
- Structuring of Mauritian based funds
- Taxation
- Conclusion

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Foreign Institutional Investment in India

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Who is a Foreign Institutional Investor

A foreign Institutional Investor (an "**FII**") as an institution established or incorporated outside India which proposes to make investment in India in securities of companies incorporated in India ("**Indian Companies**")[1].

Registration with the SEBI

FIIs seeking to invest in Indian Companies are required to be registered with the Securities and Exchange Board of India (the "**SEBI**"). Such FIIs would have to comply with the provisions of the Guidelines for Foreign Institutional Investors[2] and the Securities and Exchange Board of India (Foreign Institutional Investors) Regulations, 1995 (the "**SEBI Regulations**"). An FII seeking registration would have to apply to the SEBI on Form A. The application form along with the enclosures have to be submitted to the SEBI in duplicate. The application includes an application to the Reserve Bank of India (the "**RBI**") for the required permission under the Foreign Exchange Regulation Act, 1973. The SEBI provides a single window clearance for all such applications. The application on Form A is required to be accompanied by the following documents:

- Copies of memorandum of association and articles of association of the FII.
- Brochures of the FII and its parent/group company.
- Copy of the investment management agreements or any other agreements authorizing the FII to invest on behalf of its sub-accounts/clients.
- Audited financial statements and annual reports for the last five years.
- Documents to support registration or regulation by a Securities Commission and/or Self-Regulatory Organization, or any other appropriate regulatory authority recognized by the SEBI.
- Copy of the Custodian Agreement with a custodian in India.

Criteria

- FIIs seeking a license from the SEBI are required to be registered with a recognized foreign securities regulatory authority (recognized by the SEBI) or foreign tax authority.

- They must have a five-year track record of good performance. Based on the performance of the FII, the SEBI may consider a period less than five years. If the FII

[1] Regulation 2(f) of the Securities and Exchange Board of India (Foreign Institutional Investors) Regulations, 1995.
[2] Press note, dated September 14, 1992.

is a newly organized entity, the SEBI may consider the track record of its parent/group company.

- If the FII proposes to invest directly in Indian portfolio companies it would have to be broad-based (*i.e.* it would be required to have at least fifty shareholders each holding not more than 5% of the corpus of the FII). The SEBI however considers the broad-based criteria on a look-through basis (*i.e.* if an investor in the FII holds more than 5% of that FII's corpus then such investor must itself be broad-based).

If the SEBI is satisfied that the applicant has complied with all the requirements, it will issue its "in-principle" approval. However, prior to issuing the "in-principle" approval, the SEBI will request the FII applicant to send it a name of the compliance office who will be responsible for ensuring that the FII company adhere to the guidelines. Furthermore, before issuing its "in-principle" approval, the SEBI will verify with the securities regulatory authority of the applicant's home country whether the applicant has a clean track record. On receiving an assurance that the applicant has a clean track record, the SEBI issues its "in-principle" approval to the applicant.

Fees

The SEBI charges a registration fee of US$ 10,000 (payable only by way of cheque or demand draft <u>payable at "Mumbai, India"</u>) for registering FIIs with it. The registration is valid for a period of five years and can be renewed for a further period of five years on an additional payment of US$ 10,000. Once the applicant receives the SEBI's "in-principle" approval, it would have to remit the registration fees to the SEBI. The SEBI will issue its final approval only after it receives the amount of the registration fees.

Sub-accounts

FIIs can also invest on behalf of their sub-accounts. In such cases, the sub-account would be required to register as a sub-account of an FII already registered with the SEBI. Currently no separate registration fee is payable by sub-accounts. The broad-based condition detailed hereinabove would also apply to the sub-accounts investing in Indian Companies. An entity already registered as a sub-account of an FII registered with the SEBI cannot be registered as a sub-account of another FII registered with the SEBI. The application, on Form A would have to be made by the FII on behalf of its sub-account and it would have to be accompanied by the following documents:

- Copies of memorandum of association and articles of association of the sub-account.
- Copy of the investment management agreement or any other agreements authorizing the FII registered with the SEBI to invest on behalf of the sub-account.
- Documents to support registration or regulation by a regulatory authority of the jurisdiction in which it is located.
- Copy of the Custodian Agreement with a custodian in India.

However, the SEBI is in the process of issuing a notification to the effect that the FII must give an undertaking to the SEBI (at the time of getting registered with the SEBI), that it would pay a fee of USD 1,000 to the SEBI for every sub-account that that FII wishes to register with the SEBI. Also, the notification is likely to state that henceforth, if an FII wishes to apply to the SEBI for registration of an entity as its sub-account with the SEBI, then the FII would be required to give an undertaking to the SEBI stating that the sub-account complies with the SEBI's broad-based criteria and submit a registration fee of USD 1,000 together with the completed application on Form A. It is understood that the SEBI would then immediately register the entity as a sub-account of the FII with any further delay.

Investment restrictions

FIIs registered with the SEBI can invest up to 30% of their **own corpus** in debt securities of Indian Companies. They can also invest in unlisted securities of Indian Companies and in the units of mutual funds organized in India. The aggregate non-resident Indian and persons of Indian origin (together referred to as "**NRIs**"), Overseas Corporate Body (owned to the extent of 60% or more by NRIs) ("**OCB**"), and FII investment in any Indian Company cannot exceed 24% of its paid-up share capital. The 24% limit may be increased to 30% if the board of directors of the investee Indian Company pass a resolution and the shareholders of the investee Indian Company pass a special resolution approving such investment up to 30%. An FII together with its sub-accounts cannot invest in more than 10% of an investee Indian Company. The 10% investment in an Indian Company would however apply separately to the FII and each of its sub-account, if the FII is unrelated to its sub-accounts (*i.e.* the sub-account does not belong to the FII's group). This implies that an FII can hold up to 10% in an Indian Company and its sub-accounts can each hold up to 10% in the same Indian Company subject to the overall limit of 30% aggregate NRI, OCB and FII investment in that Indian Company.

FIIs registered as debt funds with the SEBI can invest their **entire corpus** in debt securities of Indian Companies. They can also invest in dated government securities. The SEBI is also permitting FIIs not registered as debt funds to invest in government securities, including treasury bills.

Bank account and custodian

FIIs are also permitted, as a part of their registration, to open a bank account in India. Furthermore, it is mandatory for FIIs registered with the SEBI to appoint a custodian in India[3]. FIIs can purchase and sell securities of Indian Companies only through its

[3] The RBI grants permission under the Foreign Exchange Regulation Act, 1973 for the FII to open and maintain a foreign currency account, a special Non-Resident Rupee Account to which could be credited all receipts arising from the capital inflows, sale proceeds of shares, etc., dividends and invest and to appoint a custodian in India.

custodian and the deals should be routed only *via* the stock exchange. The custodian is also required to monitor the investment limits (detailed above) on each portfolio and to report on a daily basis to on Form LEC(FII) to the central office of the RBI at Mumbai.

Preferential allotment by listed Indian Companies to FIIs

FII investments by way of preferential allotments will be permitted up to 15% of the equity of a listed Indian Company subject to the condition that the aggregate FII/NRI/OCB investment does not exceed 24% (where certain conditions detailed above are complied with, the 24% ceiling may be raised to 30%) of the equity of the said Indian Company[4]. There is a lock-in period of 5 years on all investments made by FIIs on a preferential allotment basis[5].

Proprietary funds

FIIs can also use their proprietary funds for investing in Indian Companies. In such cases, the broad-based criteria is relaxed.

Forward cover

FIIs are also permitted the take forward cover on their equity[6] and debt exposure to hedge against currency fluctuations[7].

Structuring of Mauritian based funds

Funds set up in Mauritius ("**Funds**") are generally not registered with a securities regulatory authority. Furthermore, the SEBI does not recognize the Mauritius Offshore Business Activities Authority (the "**MOBAA**") as a regulatory authority and therefore, it may not be possible for the Funds to directly obtain an FII license. However, an existing investment management company (the "**Investment Manager**") of the Fund organized outside of Mauritius and registered with a recognized regulatory authority can register itself as an FII with the SEBI. The Fund can then register as a sub-account of the Investment Manager with the SEBI. The structure chart is depicted below.

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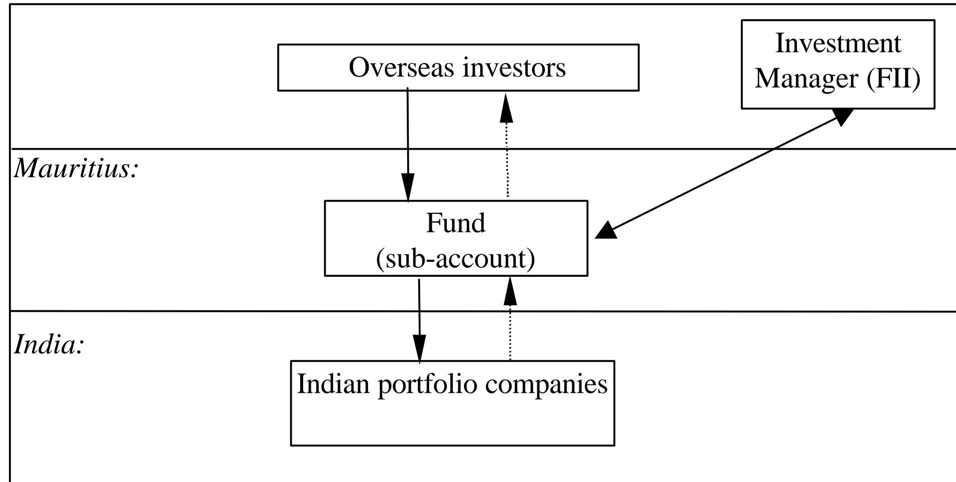
[4] Press release, dated May 13, 1994, issued by IIMARP Department, SEBI.

[5] RBI circular.

[6] All fresh investments made over the value of total equity investments of a FII outstanding as at the close of business on June 11, 1998 will be eligible for forward cover. Source: A. D. (M. A. Series) Circular No. 18, dated June 11, 1998. In respect of existing investments in equity as at the close of business on June 11, 1998, the amount eligible for cover will be the difference in dollar terms between the market value of the investments on June 11, 1998 converted at the RBI reference rate (i.e. USD 1 = 42.38) and the market value of the investment at the time of providing cover.

[7] Source: A. D. (M. A. Series) Circular No. 18, dated June 11, 1998 and Circular No. 19 dated June 16, 1998.



Taxation

Income-tax Act, 1961

- Interest earned by an entity (registered as an FII or sub-account of a registered FII) from India from its investments in listed debt securities of Indian Companies (whether or not incurred in foreign currency) will be taxed at the rate of 20% under section 115AD of the Income-tax Act, 1961 (the "**ITA**").
- Interest income of an entity (registered as an FII or sub-account of a registered FII) from debt (whether listed or unlisted) incurred in foreign currency would be taxed at the rate of 20% under section 115A of the ITA.
- Other interest income earned by an entity (registered as an FII or sub-account of a registered FII) from unlisted debt not incurred in foreign currency would be taxed at the rate of 48%.
- Long-term capital gains[8] earned by an entity (registered as an FII or sub-account of a registered FII) from sale of listed debt securities of Indian Companies would be taxed at the rate of 10% and short-term capital gains[9] would be taxed at 30% in terms of section 115AD of the ITA.
- Long-term capital gains earned by an entity (registered as an FII or sub-account of a registered FII) from sale of unlisted securities of Indian Companies would be taxed at the rate of 20% and short-term capital gains would be taxed at 48% under the ITA.
- Dividends earned by an entity (registered as an FII or sub-account of a registered FII) would not be subject to any withholding tax in India[10].

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8 Gains earned on the transfer of shares and listed securities held for a period of more than 12 months.

9 Gains earned on the transfer of shares and listed securities held for a period of 12 months or less than 12 months.

10 Section 10(33) read with section 115-O of the ITA.

India-Mauritius tax treaty

- Capital gains earned by the Fund (organized in Mauritius) registered as a sub-account of an FII from its investments in Indian Companies would be tax exempt subject to the condition that it does not have a permanent establishment in India.
- Interest income earned by the Fund (organized in Mauritius) registered as a sub-account of an FII from India from debt (whether listed or unlisted) incurred in foreign currency would be taxed at the rate of 20%.
- Interest income earned by the Fund (organized in Mauritius) registered as a sub-account of an FII from all investments in listed debt securities of Indian Companies (whether or not incurred in foreign currency) would be taxed at the rate of 20%.
- Interest income earned by the Fund (organized in Mauritius) registered as a sub-account of an FII other than that mentioned above would be taxed at the rate of 35% under the India-Mauritius tax treaty.
- Dividends earned by the Fund would not be subject to any withholding tax in India[11].

Conclusion

The Fund could be organized in a jurisdiction with which India has a favorable tax treaty and claim reduction of or exemption from tax in India. India-Mauritius tax treaty offers the benefit of complete exemption from capital gains tax in India. However, it does not offer any concessions on the withholding tax on interest. The India-U.A.E. tax treaty and India-Cyprus tax treaty also offer similar capital gains tax exemption in India. The India-U.A.E. tax treaty reduces the withholding tax on interest to 12.5% and India-Cyprus tax treaty reduces this rate to 10%.

Besides the tax concessions, Funds should also consider some other factors before selecting a particular jurisdiction. U.A.E. is not considered politically very stable. In case of Cyprus, the fund regime is not yet in place although it is considerably used for setting up holding companies. Also, Cyprus has a tainted reputation as a 'tax haven'. Given these factors, Mauritius still emerges as the most favorable jurisdictions for setting up an offshore fund for investment in India. Since the India-Mauritius tax treaty does not offer any significant advantages in respect of interest income, it may be preferable to structure investments through the mutual fund route (discussed hereinabove), thereby falling within Article 22 of the India-Mauritius tax treaty and claiming exemption from withholding tax on income from units of the mutual fund in India.

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[11] Section 10(33) read with section 115-O of the ITA.