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Indian Government Further Relaxes Rules On Qualified Foreign Investors

By Ashish Kabra, Kishore Joshi, and Siddharth Shah, of Nishith Desai Associates, Mumbai.

Background

The Qualified Foreign Investor ("QFI") route was initially introduced by the Securities Exchange Board of India ("SEBI") *vide* Circular No. CIR/IMD/DF/14/2011 dated August 9, 2011, whereby QFIs were permitted to invest in mutual fund schemes. Following on from the UK Sinha committee recommendations in 2010, the idea was to bring about disintermediation of the capital markets and to provide direct access to foreign investors, albeit through mutual funds.

Following this policy and to widen the class of investors, reduce market volatility and deepen the Indian capital market, the Ministry of Finance ("Ministry"), *vide* a press release dated January 1, 2012 ("January Press Release") (see http://finmin.nic.in/press_room/2012/QFIS_invest_directMarketIndia.pdf), permitted QFIs to invest directly in the Indian equities market (*see analysis by Ashish Kabra, Ruchi Biyani, Kishore Joshi, and Siddharth Shah, of Nishith Desai Associates, Mumbai, at WSLR, January 2012, page 22*).

Pursuant to the January Press Release, on January 13, 2012, SEBI, *vide* Circular No. CIR/IMD/FII&C/3/2012 ("SEBI Circular") (see http://www.sebi.gov.in/sebiweb/home/list/1/7/0/0/Circulars), and the Reserve Bank of India ("RBI"), *vide* A.P. (DIR Series) Circular No. 66 ("RBI Circular") (see http://www.rbi.org.in/scripts/BS_CircularIndexDisplay.aspx?Id=6937), formalized the scheme for investment by QFIs in equity shares of Indian companies.

This marked the opening of a completely new route for foreign investors, allowing direct access to listed Indian equities without requiring them to be registered with SEBI or the RBI. However, the route in effect failed to take, due to a number of reasons. The route was fraught with uncertainty and ambiguity. There was lack of clarity on various aspects, especially for qualified depository participants ("QDPs"), on whose shoulders SEBI had placed the entire responsibility for ensuring compliance with the regulations and laws. QDPs were wary of how to comply with the cumbersome administrative responsibilities imposed on them by SEBI, and the route received a highly negative feedback from the market, to the extent that the QFI route was practically never used by any foreign investors.

Thus, to augment foreign inflows, which have been dwindling over the last several months, and to rationalize the route, based on the market feedback, the Ministry has now, *vide* a press release dated May 29, 2012 ("Press Release") (see http://finmin.nic.in/press_room/2012/Rational_QFI_Scheme.pdf), taken various measures to remove the bottlenecks and stimulate foreign investments via this route.

The Press Release

QFI Investment in Corporate Bonds

The Press Release, which incorporates the budget proposal for QFIs, has permitted QFIs to invest in corporate bonds and mutual fund debt schemes. A separate sub-limit of U.S.$1 billion has been created for the purposes of QFI investment in such corporate bonds and mutual fund debt schemes.

This shall clearly provide a fillip to foreign inflows. There is a significant appetite for debt investments amongst foreign investors, especially high net worth individuals ("HNIs"), who are enticed by the high level of interest rates and returns that debt investments offer. The QFI route shall provide a direct option for foreign investors that were previously forced to invest in non – convertible debentures listed on the stock exchange through the Foreign Institutional Investor ("FII") route.

However, what is not clear from the Press Release is, as in case of FIIs that are permitted to invest in listed or to be listed corporate bonds, whether QFIs would be allowed to invest in unlisted corporate bonds. The RBI circular will be important in this regard to provide clarity on this issue.

Widening of QFI Compliant Jurisdictions

There was a lot of ambiguity surrounding the jurisdictions whose residents would be eligible to qualify as QFIs. For a resident of a particular jurisdiction to qualify as a QFI, the country was required to be a signatory to the International Organization of Securities Commissions' ("IOSCO's") Multilateral Memorandum of Understanding and to be compliant with Financial Action Task Force ("FATF") standards.

SEBI was of the view that only the 34 FATF member states would be regarded as compliant with FATF standards for the purposes of the QFI definition. This gave rise to a lot of debate, as there are a significant number of jurisdictions which are compliant with the FATF standards but are not direct members of the FATF. The understanding significantly limited the use of the QFI route and left out a number of important jurisdictions from which foreign investment would have come in. The European Union and the Gulf Cooperation Council ("GCC") as bodies are members of the FATF, but not every country that is a member of the European Union or the GCC in its individual capacity is an FATF member. Thus, there was a lot of uncertainty as to whether the member countries of such bodies would satisfy the QFI requirement in accordance with the regulatory view.

The Government has now, with the Press Release, clarified that the residents of the six member countries of the GCC (see http://www.gcc-sg.org/eng/) and the 27 member countries of the European Union (see http://ec.europa.eu/represent_en.htm) would be eligible to be considered as QFIs. This is a significant change, as it substantially widens the QFI route, incorporating within its folds a number of important jurisdictions. Countries, such as Cyprus, which have favorable tax treaties with India are now eligible jurisdictions under the QFI route. Needless to say, Mauritius, in spite of its strong know your customer and money laundering laws, would still remain out of bounds from a QFI perspective.

Removal of Five-Day Limit

Previously under the SEBI Circular, the funds remitted in the Indian rupee account by a QFI for investments was required to be transferred to the designated overseas bank account of the QFI, if such funds were not invested within five working days of the receipt of funds in the QFI's account. This was seen as a serious hindrance for both 1) QDPs as an administrative hassle, as they were responsible for ensuring that the money was immediately remitted back to the designated overseas account of the QFI after five days, and 2) QFIs, as they became highly prone to exchange rate fluctuations.

The Ministry has now under the Press Release decided to dispense with this limit of five days, allowing the QFI to have the freedom to retain the amounts in its account in India, reducing the high cost of the transfer of funds, which acted as a serious hindrance for QFI investments. This also brings parity with the FII route, wherein FIIs are free to retain the funds in the designated rupee account without any time restriction on repatriation.

Freedom to Open a Separate Account

Previously, QFIs were allowed to invest only through the rupee pool bank account of their QDP. This was not appreciated by such foreign investors, as their monies were pooled at the QDP level and kept along with the investments of other QFIs. Also, this put the onus of withholding the tax on the QDPs, creating a huge liability risk.

The Press Release now permits QFIs to open separate individual non-interest-bearing rupee bank accounts with authorized dealer banks in India to undertake transactions under this route. This provides a significant comfort to QDPs, which were previously highly apprehensive about how to deal with the withholding obligation, as each QFI, depending on the jurisdiction it came from, would be subject to a different withholding rate. Also, this now provides clarity in the case of interest payments on debt investments made by QFIs.

Lastly, the Press Release requires the Indian regulators, *i.e.*, SEBI and the RBI, to come out with the relevant circulars to incorporate and operationalize the changes. Also, the Central Board of Direct Taxes is required to issue relevant clarifications pertaining to tax-related issues, especially as to withholding obligations.

Conclusion

Although the QFI route was introduced almost 10 months ago with the intention to increase the level of foreign investment into India, the route never took off and remained unutilized. This Press Release is a strong indication that the Government of India has recognized the initial failure of the route and has positively acted on the feedback received from market players. We hope that this relaxation in the QFI regime encourages foreign investors to commence investing in India.

The Ministry of Finance's May 29, 2012, Press Release can be accessed at http://finmin.nic.in/press_room/2012/Rational_QFI_Scheme.pdf.

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