

Corpsec Hotline

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WELCOME QFIS: A NEW ENTRY ROUTE TO CAPITAL MARKETS FOR FOREIGN INVESTORS

INTRODUCTION

With the start of 2012, the Government has made a strong bid to strengthen the domestic markets by proposing to allow Qualified Foreign Investors ("QFIs") to invest directly into the Indian equity market vide press release dated January 1, 2012 issued by the Ministry of Finance ("Press Release"¹). The proposed new investment route is aimed at providing stimulus to the markets which lacked luster at the end of 2011. The proposed new regime was part of the recommendation made by Department of Economic Affairs in its report issued in June 2010.²

BACKGROUND

Currently, investments by Securities Exchange Board of India ("SEBI") registered Foreign Institutional Investors ("FIIs") or sub-accounts of FIIs or investment by non-resident Indians ("NRIs") under the portfolio investment scheme ("PIS") are the only means of directly making investments into listed Indian companies on the floor of the stock exchange. In addition to the above, recently in consonance with the policy of liberalization, SEBI vide circular dated August 9, 2011 ("Mutual Fund Circular") permitted QFIs to invest into mutual fund schemes, thereby providing an indirect way of making foreign investments into Indian equity markets.

THE PROPOSED NEW REGIME

The Government has made a bold move to provide a fillip to foreign inflows into the country and to bolster the Indian capital markets. The Press Release allows QFIs to make direct equity investments into the securities of Indian companies on the floor of the stock exchange. The rationale provided under the Press Release for such policy shift is "to widen the class of investors, attract more foreign funds, and reduce market volatility and to deepen the Indian capital market. QFIs have been already permitted to have direct access to Indian Mutual Funds schemes pursuant to the Budget announcement 2011-12. Today's decision is a next logical step in the direction."

The Press Release further states that the SEBI and RBI are expected to issue the relevant circulars to operationalise the proposed new regime by January 15, 2012

KEY HIGHLIGHTS OF THE PROPOSED NEW REGIME AS PROVIDED UNDER THE PRESS RELEASE

RBI to grant general permission (i.e. under the automatic route) to QFIs for investment under PIS route similar to FIIs.

The investment by QFIs would be subject to an individual investment limit of 5% of the paid up capital of the Indian company and an aggregate investment limit of 10% of the paid up capital of the company. These limits are over and above the limits applicable in case of investment by FIIs³ or NRIs under PIS route⁴.

QFIs would be allowed to invest only through a SEBI registered qualified depository participant ("DP") and all the transactions would have to be made through this DP only.

DPs would be the ones who would be required to ensure that the QFIs comply with the KYC norms and the stipulated regulatory requirements.

ANALYSIS

Scope of QFIs: As highlighted in the Press Release, the first step taken in the direction of liberalization in 2011 was to allow QFIs to invest into mutual fund schemes vide the Mutual Fund Circular and that

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permitting QFIs to invest directly into the listed scripts is the next logical step.

Under the aforesaid Mutual Fund Circular, QFIs are defined to mean "a person⁵ resident in a country that is compliant with Financial Action Task Force ("**FATF**") standards and that is a signatory to International Organization of Securities Commission's ("**IOSCO's**") Multilateral Memorandum of Understanding, provided that such person is not resident in India, provided further that such person is not registered with SEBI as Foreign Institutional Investor or Sub-account."

This above definition is very wide in its scope and ambit as a majority of the countries are compliant with the FATF standards and are the signatories to the IOSCO's multilateral memorandum of understanding. This would allow a large group of foreign investors direct access to the Indian equity market instead of investing through FII/sub-accounts and at the same time will provide wider opportunity to the Indian companies to raise funds.

Future of FII/sub-account route: Under the current SEBI (Foreign Institutional Investors) Regulations, 1995 ("**FII Regulations**"), there are stringent conditions imposed on the registration of FIIs and sub-accounts such as if an asset management company or an investment advisor has to be registered as an FII, it has to indicate that it is proposing to make investments on behalf of broad based⁶ funds. Further, funds can be registered as sub-accounts only if they fulfill the broad based criteria. Similarly, if an individual wants to register as a sub-account, then inter alia he has to fulfill minimum net worth criteria of USD 50 million.

The recent Press Release does not propose any registration / eligibility requirements upon QFIs. However, as we await the regulatory framework applicable to investments by QFIs, imposition of any such similar onerous conditions on QFIs would make this investment route equivalent with the FII regime and would defeat the intent of liberalization. However, the flip side of the story is that in the above scenario it needs to be seen what remains of the FII route, as entities would prefer to invest directly as QFIs, rather than seeking a registration under the FII route and complying with its cumbersome requirements.

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Individual investments possible: Unlike FIIs, where there is a definite intent of SEBI to move towards broad based investments, this QFI regime may provide opportunities to individuals to invest on their own account and thereby facilitate them to hold Indian portfolios distinct from the other investors.

Further, until now SEBI was not comfortable giving sub-account registration to foreign individuals / foreign corporates. However, with the introduction of the new liberalised regime, such foreign individual / foreign corporate may have a new avenue to invest in Indian listed entities.

Investment by NRIs covered or not: The Mutual Fund Circular which brought in the regulatory framework for investment by QFIs into mutual fund schemes did not specifically exclude NRIs from the definition of QFIs, as it did in the case of FIIs and sub-accounts. Thus, NRIs may have been allowed to make investments into mutual funds as QFIs.

The Press Release while explaining QFIs also fails to exclude NRIs from its ambit. However, the Press Release provides that the investment limits prescribed for QFIs shall be over and above the FII and NRI investment ceilings under the PIS. Thus, it has to be seen if the fine print of law relating to QFIs would specifically exclude NRIs from its ambit or would it leave the place for NRIs to make investments into Indian entities as QFIs. Considering that a separate PIS route is already available to NRIs, it is unlikely that NRIs may be allowed to invest through the QFI route.

KEY IMPLICATIONS OF THE PROPOSED NEW REGIME

This move leads to further dis-intermediation of the capital markets for foreign investors who were earlier forced to come through the FII route.

Depending on the eligibility criteria that may be prescribed for QFIs, this could potentially have a knock-on effect on FII and sub-account eligibility criteria leading to easing of the norms for such registrations.

It needs to be seen how the limits are monitored for entities who may also come in under the QFI route. This easier access to Indian stocks could further bring more transparency in terms of beneficial owner

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as against the offshore derivative instruments which have always attracted the ire of the regulators for their perceived lack of transparency.

It needs to be seen if this route which is now open only for equity securities would be extended to listed debt and derivative instruments as well in future.

Conclusion

Considering the grim state of capital markets across the globe generally, the introduction of the proposed QFI route would augur well for the Government to stimulate investment activity. While the issuance of Press Release is a proactive step by the Government to address the changing need of the times, only upon release of the fine print of the regulatory framework governing QFIs, one would be able to determine whether the QFI route would provide greater attraction to foreign investors as compared to the extant investment regimes.

Therefore, it's now for the regulators to draft QFI regulatory framework in line with the intent of the Government. Imposition of any onerous conditions or restrictions would simply cause to add the QFI route to the already existing FII/sub-account and the NRI investments routes without providing boost to foreign inflows.

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You can direct your queries or comments to the authors

¹ <http://pib.nic.in/newsite/erelease.aspx?relid=79306>

² Report of the Working Group on Foreign Investments – June 2010

³ The total holding by each FII/SEBI approved broad based sub-account of FII shall not exceed 10% (5% in case of foreign corporate or foreign individual sub-accounts) of the total paid up equity capital issued by an Indian company and the total holdings of all FIIs/sub-accounts of FIIs put together shall not exceed 24% of the paid-up equity capital. Provided that this limit of 24% may be increased to the sectoral cap/statutory ceiling by the Indian company, by passing a resolution by its board of directors followed by passing of a special resolution to that effect by its general body.

⁴ The paid up capital of shares of an Indian Company, purchased by each NRI, both on repatriation and on non-repatriation basis, should not exceed 5% of the paid up value of shares issued by the Company concerned. Further the total shares of any company purchased by all NRIs should not exceed 10% of the paid-up capital of the company. Provided that this aggregate ceiling of 10% may be raised to 24% by passing a special resolution.

⁵ As per explanation to paragraph 3 of Mutual Fund Circular," the term "Person" shall carry the same meaning under Section 2(31) of the Income Tax Act, 1961." Section 2(31) of the Income Tax Act, 1961 defines a Person as "person" includes—

- an individual,
- i. a Hindu undivided family,
- ii. a company,
- iii. a firm,
- iv. an association of persons or a body of individuals, whether incorporated or not,
- v. a local authority, and
- vi. every artificial juridical person, not falling within any of the preceding sub-clauses.

Explanation.—For the purposes of this clause, an association of persons or a body of individuals or a local authority or an artificial juridical person shall be deemed to be a person, whether or not such person or body or authority or juridical person was formed or established or incorporated with the object of deriving income, profits or gains;"

⁶ As per the explanation to Regulation 6 of the SEBI (Foreign Institutional Investors) Regulations, 1995, "broad based fund" means "a fund, established or incorporated outside India, which has at least twenty investors, with no single individual investor holding more than 49% of the shares or units of the fund:

Provided that if the broad based fund has institutional investor(s), it shall not be necessary for the fund to have twenty investor:

Provided further that if the broad based fund has an institutional investor who holds more than 49% of the shares or units in the fund, then the institutional investor must itself be a broad based fund;"

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