

Corpsec Hotline

June 02, 2012

QFIS: THE NEW INVESTMENT ROUTE OF CHOICE

In light of the recent press release of the Ministry of Finance dated May 29, 2012 on Qualified Foreign Investors, we are organizing an interactive audio call to provide our views and insights.

Speaker: Mr. Siddharth Shah

Date: Wednesday, June 6, 2012

Time: 6:00 p.m. (IST)

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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 U K 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 to deepen the Indian capital market, the Ministry of Finance (“**Ministry**”) had vide press release dated January 1, 2012 (“**January Press Release**”)¹ permitted QFIs to invest directly into the Indian equities market. In pursuance to the January Press Release, on January 13, 2012 SEBI vide Circular No. CIR/IMD/FII&C/3/2012 (“**SEBI Circular**”)² and the Reserve Bank of India (“**RBI**”) vide A.P. (DIR Series) Circular No. 66 (“**RBI Circular**”)³ formalized the scheme for investment by Qualified Foreign Investors (“**QFIs**”) in equity shares of Indian companies.

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

Thus to augment the 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 press release dated May 29, 2012 (“**Press Release**”)⁴ 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 incorporating the budget proposal for QFIs, has permitted QFIs to invest in corporate bonds and mutual fund debt schemes. A separate sub-limit of USD 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 the foreign investors, especially the 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 to the foreign investors who were previously forced to invest in non – convertible debentures listed on the stock exchange through the foreign institutional investments route. What is however not clear from this press release is as in case of FIIs who are permitted to invest into listed or to be listed corporate bonds, whether QFIs would be allowed to invest in unlisted corporate bonds. RBI circular in this regard will be important to get clarity on the above.

Widening of QFI Compliant Jurisdiction:

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There was a lot of ambiguity surrounding the jurisdictions, the residents of which would be eligible to qualify as a QFI. 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 Commission's ("IOSCO's") Multilateral Memorandum of Understanding and be compliant with the 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 heat and debate as there are a significant number of jurisdictions which are compliant with the FATF standards, but are not a direct member of the FATF. The understanding significantly limited the use of the route and left out a number of important jurisdictions from where the foreign investment would have come in. The European Commission ("EC") and the Gulf Cooperation Council ("GCC") as a body are members of FATF and not every country which is member of the EC and GCC in its individual capacity is an FATF member. Thus lot of uncertainty was prevailing on whether the member countries of such bodies would satisfy the QFI requirement in accordance with regulatory view.

The Government has now under the Press Release clarified that the residents of the 6 member countries of the GCC⁵ and the 27 member countries of the EC⁶ 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 as a jurisdiction in spite of its strong KYC and money laundering laws would still remain out of bound from a QFI perspective.

Removal of 5 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 their accounts. This was seen as a serious hindrance for both (i) the QDPs, as an administrative hassle as they were responsible for ensuring that the money is immediately remitted back to the designated overseas account of the QFI after five days and (ii) the QFIs, as they became highly prone to the 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 the account in India, reducing the high cost of transfer of funds that otherwise was acting 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, the QFIs were allowed to invest only through the rupee pool bank account of their QDP. This was not appreciated by the foreign investor 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 Account with Authorized Dealer banks in India to undertake transactions under this route. This provides a significant comfort to the QDPs who were previously highly apprehensive about how to deal with the withholding obligation as each QFI depending on the jurisdiction they were coming from would be subject to a different withholding rate. Also, this now provides clarity in case of interest payments on debt investments made by QFIs.

Lastly the Press Release requires the regulators i.e. SEBI and the Reserve Bank of India 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 the tax related issues, especially on the withholding obligations.

CONCLUSION

Though the QFI route had been introduced almost 10 months back with the intention to increase the level of foreign investments into India, the route never took off and remained unutilized. This Press Release is a strong indicative that the government of India has recognized the initial failure of the route and has positively acted on the feedback obtained from the market players. We hope that this relaxation in the QFI regime encourages the foreign investors to commence investing in India.

– Ashish Kabra, Kishore Joshi & Siddharth Shah
You can direct your queries or comments to the authors

¹ http://finmin.nic.in/press_room/2012/QFIS_invest_directMarketIndia.pdf

² <http://www.sebi.gov.in/sebiweb/home/list/1/7/0/0/Circulars>

³ http://www.rbi.org.in/scripts/BS_CircularIndexDisplay.aspx?id=6937

⁴ http://finmin.nic.in/press_room/2012/Rational_QFI_Scheme.pdf

⁵ <http://www.gcc-sg.org/eng/>

⁶ <http://www.gcc-sg.org/eng/>

⁶ http://ec.europa.eu/represent_en.htm

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