Corpsec Hotline

July 27, 2012

FURTHER LIBERALIZATION IN QFI INVESTMENT - WILL THIS ROUTE TAKE OFF NOW?

BACKGROUND

The Ministry of Finance had issued a press release dated May 29, 2011 ("**Press Release**") in order to make further liberalizations in the investment regime for qualified foreign investors ("QFI") under the portfolio investment scheme ("PIS"), such as allowing QFIs to invest in debt securities. The intent behind issuance of the Press Release was to attract foreign inflows under this route as the foreign inflows under this route was NIL since its introduction in August 2011. For detailed analysis of the Press Release, kindly refer to our hotline titled '*QFIs: THE NEW INVESTMENT ROUTE OF CHOICE*'.

In order to give effect to the above recommendations made in the Press Release, Securities and Exchange Board of India ("SEBI") issued a circular no. CIR/IMD/FII & C/13/2012 dated June 07, 2012.

Subsequently, the Reserve Bank of India ("RBI") has now issued a circular on July 16, 2012 ("RBI Circular") with a view to allow QFIs to invest in debt instruments which was already notified in SEBI Circular pursuant to the Press Release. With this amendment, QFIs have now been permitted to invest in the following debt securities:

1. Listed and to be listed non-convertible bonds ("NCDs");
2. Listed and to be listed bonds of Indian companies; and
3. Listed units of mutual fund debt schemes.

Thus, the QFIs are now eligible to invest in above-said debt securities ("Eligible Debt Securities"), in addition to the units of mutual funds and shares of listed Indian companies, subject to the conditions prescribed by SEBI and RBI from time to time.

SEBI has also issued two circulars in addition to above circular. The second circular was issued on July 18, 2012 which lays down the specific guidelines for the use and allocation of the debt limits available to QFIs to invest in Eligible Debt Securities. The third circular was issued on July 20, 2012which amends the definition of QFI and also relaxes certain norms with respect to QFIs investment in mutual funds which invest in infrastructure.

SALIENT FEATURES OF THE CHANGES MADE TO QFI REGIME

Eligible instruments and eligible transactions

With this amendment, QFIs are allowed to invest in Eligible Debt Securities. Such investment can be made through direct subscription or through a recognized stock broker on a recognized stock exchange in India.

The RBI Circular has clarified that the QFIs, like foreign institutional investors ("FIIs"), are allowed to invest in primary issuances ('to be listed') of NCDs and bonds by an Indian company if the listing of such NCDs/bonds is committed to be done within 15 days from the date of such investment. FIIs had been previously permitted to invest in 'to be listed' NCDs and bonds vide A.P. (DIR Series) Circular No. 89 dated March 1, 2012. The provisions of the said circular would apply to QFIs in the same manner as it applies to FIIs. An analysis of the said circular is provided in our hotline titled 'RBI WELCOMES FIIs TO PRIMARY BOND ISSUANCES!'.

The extension of the permission to invest in 'to be listed' bonds and debentures, alleviates the needs for a warehousing entity for QFIs as well bringing them at par with the FIIs from a feasibility perspective. Thus the change categorically shows that the government and the regulators have drawn a parallel between FIIs and QFIs.

Further, QFIs can sell the investment made in Eligible Debt Securities on a recognized stock exchange through a recognized stock broker or by way of buyback or redemption by the issuer.

Allocation of the Debt Limits:

The overall investment by QFIs in Eligible Debt Securities shall not be more than USD 1 billion and such investment shall not be subject to any lock–in or residual maturity clause. The RBI has also clarified that the limit on investment by QFIs shall be over and above USD 20 million allowed for investment by FIIs in corporate debt.

The second circular issued by SEBI on July 18, 2012 has now laid down how the limit of USD 1 billion would be utilized by the QFIs to invest in Eligible Debt Securities. As per this circular, QFIs may invest in Eligible Debt Securities without any permission until the aggregate investment by all the QFIs reach 90% of the debt limit i.e. USD 0.9 billion. Thereafter QFIs would be allocated the balance debt limit on a first come first serve basis, wherein the depositories would on each day after the market hours coordinate with each other to provide approval to the requests based on the time of the receipt of the request.

However, there is no individual investment limit specified for the QFI investment in Eligible Debt Securities, as opposed to FIIs wherein there is a cap on the amount of limit a FII could bid for.

Hedging

Previously, one of the major dampener for the QFI route was the inability of the QFIs to hedge themselves against the risk arising from exchange rate fluctuations, especially in the current environment where the value of Rupee has depreciated considerably. The circular alleviates this risk in as much as the QFIs are now permitted to hedge their currency risk arising on account of their permissible investments under the QFI route, in accordance with the guidelines issued by the RBI.

Change of definition of QFIs

It may be noted that a person resident in India shall not qualify as QFI for the purpose of making investment under this route. As per the first circular issued by SEBI, the term "Person" and "Person resident in India" shall carry the same meaning as given under Foreign Exchange Management Act, 1999 ("**FEMA**") and section 2(31) of the Income Tax Act, 1961 ("**IT Act**"). As per this, it appears that an investor who would like to qualify as a QFI must have to fulfill the definition of "Person" and "Person resident in India" under both the statutes. This tends to create confusion in the minds of investors and would be practically difficult to satisfy the criteria mentioned under both the statutes since the definition given under FEMA is not the same as given under the IT Act.

SEBI in its circular issued on July 20, 2012 has now clarified that the above terms ("Person" and "Person resident in India") shall carry the meaning given under the IT Act only. This clarification is really helpful as it would assist the prospective investors to check their eligibility under this regime without any hassle.

Other conditions

1. Both Qualified Depository Participants ("**QDPs**") and AD – Category I banks ("**AD**") will have to ensure KYC compliance for the QFIs as per the applicable norms;
2. QFIs will have to remit foreign inward remittance through normal banking channels in any permitted currency (freely convertible) directly into the single non-interest bearing rupee account;
3. The pricing of all the eligible transactions and investment in all eligible securities by QFIs shall be in accordance with the relevant and applicable guidelines issued from time to time;
4. QFIs and ADs will also have to report the transactions to the RBI in a manner and format prescribed by the RBI in addition to reporting of transactions to SEBI on periodical basis.

CONCLUSION

It may be recalled that the government conducted roadshows in the recent past in five gulf nations -Riyadh, Dubai, Muscat, Kuwait and Bahrain - to attract investments. During this roadshow, the officials of the government also met some of the potential QFIs. These circulars are part of the sincere effort being employed by the government to improve the sentiments of the foreign investors by providing them a hassle free access to the Indian market and to boost the foreign inflows in India in the coming months. There still remain unaddressed questions on the QFI regime viz. the extent of KYC required to be undertaken by QDP in case of pooled funds or omnibus accounts, who would be held responsible for payment of taxes whether the QDP or the QFI, whether it would be mandatory for a QFI to file tax returns in India, whether and how netting off of profits and losses will be permitted for QFIs, etc. However, the approach of the government at this juncture clearly appears to be extremely positive and determined to make this regime practical and successful and we are hopeful that many of the above issues are likely to be resolved over the coming months. The move towards disintermediation of the Indian market seems to be gaining momentum and QFI route seems to be the answer for an efficient and a transparent market access to foreign investors.

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