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Foreign Portfolio Investors' Regulations– Proposed Changes

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Recommended by:

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As the fastest growing major economy in the world, India is an important participant in global investment flows. Overseas funds flow in India both through the Foreign Portfolio Investors ("**FPIs**") and the Foreign Direct Investment ("**FDI**") routes with substantial inflows into capital markets. In order to rationalize the investment routes and monitoring of FPIs, the SEBI (Foreign Portfolio Investors) Regulations, 2014 ("**FPI Regulations**") were notified on January 07, 2014. Over the years, several clarifications, circulars and guidelines have been issued to the FPI Regulations and a need was felt to undertake an extensive review of the FPI regime to consolidate and rationalize the FPI framework.

SEBI therefore constituted a working group under the chairmanship of Shri. Harun R. Khan (Retd. Deputy Governor of Reserve Bank of India) ("**Working Committee**"), to review the FPI Regulations and operational guidelines and circulars issued thereunder to simplify the language and complexities in the FPI Regulations. The Working Committee submitted its report titled 'Report of the working group on the SEBI (Foreign Portfolio Investors) Regulations, 2014' ("**Report**") and has, *inter-alia*, proposed the following key recommendations:

(a) Fast track on-boarding process for Category II FPIs. The Working Committee has recommended a fast track registration and KYC process on the basis of a risk-based approach to bring efficiency in the FPI on-boarding process and simplify the documentation requirements for the following investors:

i. Public retail funds coming from countries that are Financial Action Task Force ("**FATF**") Member; or

ii. Applicants seeking registration as non-investing FPIs from countries that are FATF Member;

iii. Applicants intending to invest only in Government securities (including Central Government securities, State Development Loans or Municipal Bonds) or units of mutual funds;

iv. Applicants seeking to invest only through Voluntary Retention Route (VRR).

(b) Liberalized investment cap. In terms of the extant Foreign Exchange Management (Transfer or Issue of Security by a Person Resident Outside India) Regulations, 2017 (“**FEMA Regulations**”) read with the Master Direction on Foreign Investments in India as updated up to March 8, 2019, the total holding by each FPI or an investor group as referred in FPI Regulations, should be less than ten per cent (10%) of the total paid-up equity capital on a fully diluted basis or less than ten per cent (10%) of the paid-up value of each series of debentures or preference shares or share warrants issued by an Indian company and the total holdings of all FPIs put together should not exceed twenty-four per cent (24%) of paid-up equity capital on a fully diluted basis or paid up value of each series of debentures or preference shares or warrants. The limit of ten percent (10%) and twenty-four percent (24%) will be called individual and aggregate limit, respectively. However, such an aggregate limit of 24 percent can be increased by the Indian company up to the total foreign investment sectoral cap/ceiling with the approval of its board of directors and shareholders through a resolution and special resolution, respectively.

The Working Committee observed that many listed companies have not taken any initiative to increase this investment cap. Therefore, the Working Committee recommended that investment by FPIs can be increased by setting the default FPI aggregate investment limit to the sectoral cap and the Indian companies be permitted to decrease the aggregate limit *to* 24% or 49% or 74%, as they deemed fit, with the approval of their Board of Directors and its General Body through a resolution.

Interestingly, the Budget for the financial year 2019-2020 considered the above recommendations and proposed a few substantial changes in the FPI Regulations, including the proposal to (i) increase the statutory limit for FPI investment in a company from the current 24% limit to the sectoral foreign investment limit with the option given to the concerned company to limit it to a lower threshold; (ii) to permit FPIs to subscribe to listed debt securities issued by Real Estate Investment Trusts and Infrastructure Investment Trusts; and (iii) to ease Know Your Customer (“**KYC**”) norms for FPIs.

(c) Review of prohibited sector for foreign investment for FPIs. In accordance with Regulation 15 of FEMA 20 (R)/2017-RB dated 07 November 2017, certain prohibited activities have been prescribed for investment by a person resident outside India. However, the Working Committee noted that as the FPIs can only acquire less than 10% stake in such companies as portfolio investment and do not take strategic interest, the FPI investment should not be equated at par with FDI and the regulations should not restrict FPI’s investments in such restricted sectors in India. However, such FPIs existing investments, including ADR and GDR, may not exceed 49%.

(d) Simplified KYC framework and verification of PAN for KYC. SEBI requested the Working Committee to examine issues arising out of the SEBI circular dated April 10, 2018 on KYC requirements for FPIs. The Working Group made several recommendations on the subject and the recommendations formed the basis of directions issued by SEBI on September 21, 2018 and December 13, 2018, establishing revised KYC framework for FPIs. The key highlights of the recommendations were:

(i) Separation of eligibility and clubbing requirements from beneficial ownership requirements as provided under Prevention of Money Laundering Act, 2002.
(ii) Permitting NRIs/OCIs/ Resident Indians as constituents of an FPI up to prescribed threshold.
(iii) Allowing NRIs/ OCIs/ Resident Indians controlled investment manager to be in control of FPIs.
(iv) Permitting NRIs/ OCIs/ Resident Indians as Senior Managing Officials (SMOs) and doing away with clubbing of investments based on common SMO.

The Working Committee also recommended that for opening of accounts with local custodians in a quick time, verification of PAN on the specified website of the Income tax authorities should be sufficient and there should be no need to provide/receive PAN cards. Alternatively, e-PAN issued by CBDT can also be produced by FPI for KYC compliance without requiring any certifications.

The Budget 2019 has also proposed to rationalize and streamline the existing KYC norms for FPIs to make it more investor friendly without compromising the integrity of cross-border capital flows.

(e) Separate registration is proposed for each sub-fund having segregated portfolio investing in India. It is also suggested to involve the Income Tax department for issuance of separate PAN for each sub fund(s).

(f) FPIs should be permitted off-market transfer of securities which are unlisted, suspended or illiquid, to a domestic investor for ease of investment.

SEBI vide its notice dated May 24, 2019, sought public comments on the Report. SEBI is expected to bring changes and consolidation of FPI Regulations basis the recommendations given in the Report after receiving public comments.

Conclusion:

As is evident from the inflow of overseas funds in the capital markets through FPIs in the last 4-5 years that FPIs are an important source of funding and the Government has recognised the need to ensure a more transparent legal and regulatory regime in India for hassle free investments by FPIs. This is evident from the FPI friendly recommendations made by the Working Committee, some of which recommendations has already found a mention in the Budget 2019, which is a welcome move to boost Indian economy.

Feedback