SEBI norms for FPI

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***Source**: Business Standard*

Manifest pedagogy: FPI issues are important with respect to various changes proposed in KYC norms, surcharge and their relationship with Indian market as a whole. It is not only important as a topic for financial sector reforms but also carrying forward the agenda of LPG or Second generation reforms.

In news: SEBI has reviewed norms for FPI

Placing it in syllabus: Changes in economic policies (explicitly mentioned)

Static dimensions:

- What are FPI
- What are QFI
- Participatory notes (P- Notes)

Current dimensions:

- Controversy regarding KYC norms
- Changes made by SEBI
- FPI surcharge and roll back

Content: The Securities and Exchange Board of India (SEBI) has eased the process for on-boarding overseas investors. It has also introduced an 'informant mechanism' to gather better evidence and crack down on insider-trading cases. Now the Foreign Portfolio Investors (FPIs) would no longer be required to meet the 'broad-basing' criteria, under which at least 20 investors were required to establish a fund. Offshore funds floated by Indian mutual funds will be permitted to invest in the domestic markets under the FPI route.

What are FPI?

    - Foreign portfolio investment (FPI) consists of securities and other financial assets held by investors in another country.
    - It **does not provide the investor with direct ownership of a company's assets** and is relatively liquid depending on the volatility of the market.
    - It involves the making and **holding of a passive investment of securities,** done with the **expectation of earning a return.**
    - These securities can include **stocks or American depositary receipts (ADRs)** of companies in nations other than the investor's nation.
    - Holding also includes **bonds, mutual funds, or exchange-traded funds** (ETFs) that invest in assets abroad or overseas.
    - FPI is part of a country's capital account and shown on its balance of payments (BOP).

- **Unlike FDI, FPI consists of passive ownership, investors have no control over ventures or direct ownership of a property or a stake in a company.**

What are QFI?

- The Qualified Foreign Investor (QFI) is a subcategory of FPI and refers to any **foreign individuals, groups or associations, or resident,** however, restricted to those **from a country that is a member of the Financial Action Task Force (FATF)** or a **country that is a member of a group which is a member of FATF and a country that is a signatory to International Organization of Securities Commission's (IOSCO) Multilateral Memorandum of Understanding (MMOU).**
- QFI scheme was introduced by Government of India in consultation with RBI and SEBI in the year 2011, through a Union Budget announcement.

- The **objective of enabling QFIs** is to deepen and infuse more foreign funds in the Indian capital market and to reduce market volatility.
- **Foreign institutional investors (FIIs)** and foreign venture capital investments do not come under the QFI category.
- QFIs are allowed to make investments in the following instruments by opening a demat account in any of the SEBI approved Qualified Depository Participant (QDP):

1) Equity and Debt schemes of Indian mutual funds,

2) Equity shares listed on recognized stock exchanges,

3) Equity shares offered through public offers,

4) Corporate bonds listed/to be listed on recognized stock exchanges,

5) G-Securities, T-Bills and Commercial Papers

- QFIs, have now been merged into FPI, when the FPI regulations were introduced in 2014.

Participatory notes (P-Notes):

- Foreign Institutional Investor (FII)s issue the **financial instruments** called P-Notes to investors in other countries who want to invest in Indian securities.
- P-notes are derivative instruments of underlying Indian assets and the investor remains anonymous.
- An **FII is an investor or investment fund registered in a country outside of the one in which it is investing.**
- This system lets unregistered overseas investors buy Indian shares without the need to register with the Indian regulatory body.
- These investments provide access to quick money to the Indian capital market.
- Because of the short-term nature of investing,

regulators have fewer guidelines for FIIs.

- To invest in the Indian stock markets and to avoid the cumbersome regulatory approval process, these investors trade participatory notes.
- Brokers and FIIs must register with the SEBI and they invest on behalf of the foreign investors.
- Brokers must report their participatory note issuance status to the regulatory board each quarter.
- Participatory notes are easily traded overseas through endorsement and delivery.
- Some entities route their investments through participatory notes to take advantage of tax laws that are available in certain countries.
- However, because of the anonymity, Indian regulators face difficulty determining a participatory notes original owner and end owner.
- Therefore, substantial amounts of unaccounted money enters the country through participatory notes.
- **SEBI has no jurisdiction over participatory note trading.**
- Although FIIs must register with the SEBI, the participatory notes trading among the former are not recorded.

Controversy regarding KYC norms:

Easing the regulatory framework for FPIs, SEBI recently simplified KYC requirements for them and permitted them to carry out off-market transfer of securities. FPI regulations have been redrafted based on the recommendation of a **committee headed by former RBI deputy governor H R Khan** which was setup after finance ministry had nudged SEBI to have a fresh look into the matter after some FPI lobbies expressed displeasure over some of the provisions issued in the FPI KYC circular released on August 10th, 2019.

- Apart from doing away with the broad-based eligibility criteria for institutional FPIs, under the new framework, **FPIs would be classified into two categories instead of three.**

- The requirements for issuance and subscription of offshore derivative instruments (ODIs) have also been rationalised.
- Offshore funds floated by mutual funds would be allowed to invest in the country after registration as FPIs.
- Entities established in the International Financial Services Centre (IFSC) would be deemed to have met the criteria for FPIs.
- Registration for multiple investment manager (MIM) structures has been simplified.
- To attract more overseas funds into the market, central banks that are not members of the Bank for International Settlements(BIS) would be eligible for registration as FPIs.

Changes made by SEBI:

- SEBI has recently said that it would rationalise the framework for issuance of participatory notes (P-notes).
- The changes announced with regard to the FPI framework are based on the final report submitted by the **HR Khan committee** in May, 2019.
- The easing of FPI norms comes at a time when overseas investors have pulled out over $3 billion from the domestic markets since the Union Budget.
- According to the new norms –

1. Individuals providing "credible and original information" on insider trading would be rewarded.
2. The reward will be 10 percent of the disgorgement amount up to Rs 1 crore.
3. The regulator will also put in place a protection system to protect the identity of the informant.
4. Action against those providing frivolous and vexatious information would be initiated.
5. The debt-to-equity ratio of companies doing buybacks

should be less than 2:1 on a consolidated basis.

6. However , those with non-banking financial companies (NBFC) arms would be exempt from the rule as long as the NBFC arm had a debt-to-equity ratio of less than 6:1.
7. The Credit rating agencies (CRAs) and companies would have to enter into agreements where the latter would provide “explicit consent” to give details of any delay or default in servicing such borrowing.
8. The move will provide CRAs more power to seek information from companies,
9. Easing migration of companies listed on the small and medium enterprise (SME) exchange (now called the innovators growth platform) to the main board.
10. Relaxations for issuance of municipal bonds.
11. More leeway to mutual funds for investing in unlisted non-convertible debentures (NCDs).

<u>FPI surcharge and rollback:</u>

As a part of a series of measures to boost the economy, recently Finance Minister announced the withdrawal of enhanced surcharge on short-term and long-term capital gains earned by FPIs and domestic investors. However according to CBDT this has not created a differential regime between FPIs and domestic investors.

It stated that even before Budget 2019, income arising from derivatives for the domestic investors including AIF category-III as well as for foreign investors who are not FPIs, has been treated as business income and not as capital gains, and taxed at applicable normal income tax rates.

In case of FPIs, Income Tax Act, 1961 contains special provisions for taxation of income from derivatives. Under this regime, income of FPIs arising from derivatives was treated as capital gains and liable for special rate of tax as per section 115AD of the Act.