

FOREIGN PORTFOLIO INVESTORS – SEBI AND FEMA PERSPECTIVE

Background:

Foreign Portfolio Investments (FPIs) are governed in India by SEBI (Foreign Portfolio Investors) Regulations 2014 ('SEBI FPI Regulations'), Foreign Exchange Management (Transfer or Issue of Security by a Person Resident outside India) Regulations, 2017 ('FDI Regulations') and RBI Master Direction No. 11/2017-18 on Foreign Investment in India, as amended time to time. FPI refers to foreign investment in India subject to such conditions stipulated in relevant SEBI and RBI regulations. Prior to SEBI FPI Regulations, such investments were governed by SEBI (Foreign Institutional Investors) Regulations, 1995 ('FII Regulations'), NRI Regulations and QFI Regulations issued by SEBI and RBI. India liberalized its economy in 1991 in order to save itself from severe economic crisis. While granting bailout to India at that time, World Bank and IMF stipulated many conditions and of which bringing out changes to foreign trade policy was one major item. Accordingly, India brought in FII regulations governing its foreign investments in 1995. Considering changes to global economic scenario, FII regulations were repealed and FPI regulations (subsuming FII Regulations) were brought in. In today's world, the words FII and FPI are widely used interchangeably.

Definition and Concept:

A person resident outside India may hold foreign investment either as FDI or FPI in any Indian company. As per Regulation 2 (xix) of FDI Regulations, 'Foreign Portfolio Investment' means any investment made by a person resident outside India through capital instruments where such investment is less than 10 percent of the post issue paid-up share capital on a fully diluted basis of a listed Indian company or less than 10 percent of the paid-up value of each series of capital instruments of a listed Indian company;

Explanation: The 10 percent limit for foreign portfolio investors shall be applicable to each foreign portfolio investor or an investor group as referred in SEBI FPI Regulations.

As per Regulation 2(h) of SEBI FPI Regulations, a 'foreign portfolio investor' means a person who satisfies the eligibility criteria prescribed under regulation 4 and has been registered under Chapter II of FPI regulations and shall be deemed to be an intermediary in terms of the provisions of SEBI Act. Provided that any FII or qualified foreign investor who holds a valid certificate of registration as on the date of commencement of FPI Regulations shall be deemed to be an FPI till the expiry of the block of three years for which fees have been paid as per SEBI FII Regulations.

The meaning of word 'Person' and residential status of such person shall be as per Income Tax Act. An FPI can invest in capital instruments of only listed Indian companies. Though the definition of foreign portfolio investment specifies only investment in capital instruments, FDI Regulations permit investment in securities other than capital instruments of Indian companies (listed or unlisted). Investment in capital instruments of unlisted companies shall be treated as FDI. An FPI cannot invest more than 10% of post issue paid share capital or more than 10% of paid-up value of each series of capital instruments of one company. Any investment beyond 10% will be treated as FDI at the option of such FPI. Such treatment shall continue even if such percentage holding falls below 10% subsequently.

FPI REGULATIONS UNDER SEBI

As mentioned above, FPIs are governed by SEBI (Foreign Portfolio Investors) Regulations, 2014, as amended from time to time.

Registration:

1. No person shall buy, sell or otherwise deal in securities as an FPI unless it has obtained a certificate of registration.
2. Such certificate shall be issued, up on an application being made by FPI, by a Designated Depository Participant (DDP) on behalf of SEBI, on payment of applicable registration fee as applicable to category of FPI under which it falls.
3. DDP may grant registration if it is satisfied that the applicant fulfils the eligibility criteria (discussed in subsequent paragraph).
4. DDP may seek additional information or clarifications as it deems necessary for grant of registration.
5. DDP shall endeavour to dispose the applications as soon as possible, but not later than 30 days from date of application or receipt of additional information, as applicable.
6. DDP may reject the registration if the application is not complete or is false in case of any material information. Such decision of rejection should be intimated to the applicant in writing.
7. If the applicant is aggrieved for non-grant of registration, he may apply to SEBI for consideration of his application, within 30 days of communication of decision of rejection.
8. Registration, if granted, will be permanent subject to compliance of applicable provisions and conditions by FPI.
9. An FPI may surrender his registration if he is desirous of giving up his activity, and such surrender can be accepted by DDP only up on approval from SEBI for doing so.
10. DDP may impose such conditions as SEBI may specify while accepting such surrender of registration.

Eligibility Criteria:

A DDP is required to ensure that an applicant satisfies the below criteria in order to be granted a certificate of registration as FPI, namely:

- i. The applicant is not a person resident in India
- ii. The applicant is not a non-resident Indian
- iii. The applicant is resident of a country whose securities market regulator is a signatory to IOSCO's (International Organization of Securities Commission) Multilateral Memorandum of Understanding or a signatory to bilateral Memorandum of Understanding with SEBI
- iv. The applicant being a bank, is a resident of a country whose central bank is a member of Bank for International Settlements ("BIS")
- v. The applicant is not a resident of a country which is identified by FATF as having deficiencies in relation to implementing AML laws, combatting the financing of terrorism ("CFT"), etc
- vi. The applicant is legally permitted to invest in securities outside its country
- vii. The applicant is authorized to invest as per its MOA, AOA or any other equivalent document
- viii. The applicant has sufficient exposure, financial and professional capability and good reputation of fairness and integrity
- ix. That grant of certificate is in the interest of development of securities market in India
- x. The applicant is a fit and proper person, as per SEBI (Intermediaries) Regulations
- xi. Any other criteria specified by SEBI from time to time

Categories of FPI:

An applicant shall seek registration as an FPI in one of the categories mentioned hereunder or any other category as may be specified by the Board from time to time. This classification is an improvement as compared to erstwhile FII regulations.

Category I FPI shall include:

Government and Government related investors such as Central Banks, Governmental agencies, Sovereign Wealth Funds of foreign country, and International or Multilateral organizations or agencies.

Category II FPI shall include:

- i. appropriately regulated broad based funds such as mutual funds, investment trusts, insurance/reinsurance companies;
- ii. appropriately regulated persons such as banks, asset management companies, investment managers/ advisors, portfolio managers;
- iii. broad based funds that are not appropriately regulated but whose investment manager is appropriately regulated, subject to condition that the investment manager of such broad-based fund is itself registered as Category II FPI. Also, the investment manager should undertake that it shall be responsible and liable for all acts of commission and omission of all its underlying broad-based funds and other deeds and things done by such broad-based funds under these regulations.
- iv. university funds and pension funds; and
- v. university related endowments already registered with SEBI as FII.

An applicant seeking registration as an FPI shall be considered to be "appropriately regulated" if it is regulated or supervised by the securities market regulator or the banking regulator of the concerned foreign jurisdiction, in the same capacity in which it proposes to make investments in India.

A Broad-based fund shall mean a fund, established or incorporated outside India, which has at least twenty investors, with no investor holding more than forty-nine per cent of the shares or units of the fund. Provided that if the broad-based fund has an institutional investor, who holds more than forty nine per cent of the shares or units in the fund, then such institutional investor must itself be a broad based fund.

Category III FPI shall include:

All others not eligible under Category I and II FPI, such as endowments, charitable societies, charitable trusts, foundations, corporate bodies, trusts, individuals and family offices.

Investment Conditions and Restrictions:

Chapter IV of SEBI FPI Regulations deals investment conditions and restrictions of FPI, the provisions of which are as follows:

1. An FPI shall invest only in following securities, namely
 - a. Shares, debentures and warrants of companies, listed or to be listed on a recognized stock exchange in India, through primary and secondary markets;
 - b. Units of schemes floated by domestic mutual funds, whether listed on a recognized stock exchange or not;
 - c. Units of schemes floated by a collective investment scheme;
 - d. Derivatives traded on a recognized stock exchange;
 - e. Treasury bills and dated government securities;
 - f. Commercial papers issued by an Indian company;
 - g. Rupee denominated credit enhanced bonds;
 - h. Security Receipts (SR) issued by Asset Reconstruction Companies;
 - i. Perpetual debt instruments and debt capital instruments, as specified by RBI from time to time;
 - j. Listed and unlisted non-convertible debentures/bonds issued by an Indian company in the infrastructure sector (the word 'infrastructure' as defined in extant ECB guidelines);
 - k. Non-convertible debentures or bonds issued by NBFC-Infrastructure Finance Companies;
 - l. Rupee denominated bonds (RDBO) or units issued by infrastructure debt funds;
 - m. Indian Depository Receipts (IDRs);
 - n. Unlisted non-convertible debentures / bonds issued by an Indian company subject to guidelines issued by Ministry of Corporate Affairs from time to time;
 - o. Securitized Debt Instruments, including any certificate or instrument issued by a special purpose vehicle set up for securitization of assets, with banks, financial institutions or non-banking financial institutions as originators, and a certificate or instrument issued and listed in terms of SEBI (Public Offer and Listing of Securitized Debt Instruments) Regulations, 2008;
 - p. Such other instruments specified by SEBI from time to time.
2. Following additional conditions are applicable in respect of investments in secondary market:
 - i. An FPI shall transact in securities in India only on the basis of taking and giving delivery of securities purchases or sold, other than in cases of short selling of securities, transactions in derivatives in recognized stock exchange and transaction in securities pursuant to an agreement with merchant banker in the process of market making or subscribing unsubscribed portion of issue of securities
 - ii. No transaction on stock exchange shall be carried forward
 - iii. FPI shall hold, deliver or cause to be delivered securities only in dematerialized form
 - iv. All transactions by FPI in securities shall be through SEBI registered stock brokers only, other than transactions in government securities falling under RBI purview, sale of securities in accordance with SEBI (buy-back of securities) Regulations & in response to letters of offer under SEBI (SAST) Regulations and SEBI (Delisting of Equity Shares) Regulations, transactions by Category I and III FPIs in corporate bonds, transactions on electronic book provider platform of recognized stock exchanges, etc.
3. In respect of investments in the debt securities, FPI shall also comply with terms, conditions or directions, specified or issued by SEBI or Reserve Bank of India, from time to time, in addition to above conditions specified in these regulations (discussed in subsequent paragraphs). "Debt Securities" shall include dated Government securities, commercial paper, treasury bills, listed or to be listed corporate debt, units of debt oriented mutual funds, unlisted non-convertible debentures / bonds in the infrastructure sector, security receipts issued by asset reconstruction companies or any other security, as specified by the Board from time to time.

Other Guidelines

1. An FPI shall always comply with provisions of these regulations and shall adhere to general obligations and responsibilities mentioned therein.
2. In case of jointly held depository accounts, each of joint holders shall meet the requirements specified for FPI and each shall be deemed to be holding a depository account as an FPI
3. In case the same set of beneficial owners invest through multiple entities, all such entities shall be treated as part of same investor group and investment limits of all such entities shall be clubbed at the investment limit as applicable to a single FPI.
4. An FPI or a global custodian who is acting on behalf of the FPI shall enter in to an agreement with a DDP to act as its custodian of securities before making any investment under FPI regulations.
5. An FPI shall appoint a branch of a bank authorized by RBI for opening a foreign currency denominated account or special non-resident rupee (SNRR) account before making any investment in India
6. Every FPI shall appoint a compliance officer who shall be responsible for monitoring the compliance of regulations and other applicable provisions. Such compliance officer shall immediately and independently report to SEBI and DDP of any non-compliance observed by him. In case an FPI is an individual, he himself shall be responsible for monitoring the compliances.
7. Every FPI and DDP shall keep or maintain specified records, books of account and other documents and shall preserve them for a minimum period of 5 years, subject to provisions of any other law for the time being in force.
8. SEBI may *suo motto* or on a receipt of information or complaint appoint one or more persons as inspecting authority to inspect the records, documents or books of account of DDP and other documents provided by FPIs as required under the regulations. Such inspecting authority shall submit its report, including interim reports if any, to SEBI directly.

FPI REGULATIONS UNDER FEMA

As mentioned earlier, Foreign Exchange Management (Transfer or Issue of Security by a Person Resident outside India) Regulations, 2017 ('FDI Regulations') and RBI Master Direction No. 11/2017-18 on Foreign Investment in India govern FPIs. Regulation 5(2), 5(5), 5(10), Schedules 2, 5 and 10 of said FDI Regulations provide guidelines on investment by FPIs in India.

Before going in to details, it is pertinent to understand the meaning of Capital Instruments. Capital Instruments as per Regulation 2(v) means equity shares, debentures, preference shares and share warrants issued by an Indian company. Equity shares includes partly paid shares which should be fully called up within 12 months from date of issue. Debentures and Preference Shares, for the purpose of 'Capital Instruments', shall include only those which shall be fully, compulsorily and mandatorily convertible. Non-convertible / partially convertible / optionally convertible debentures and preference shares shall be treated as debt and shall conform to FEMA ECB Regulations.

Regulations governing investments in Capital Instruments:

As per Regulation 5(2), an FPI can purchase or sell capital instruments of a listed Indian company on a recognized stock exchange in the manner and subject to conditions provided in Schedule 2, which are mentioned below:

1. The total holding by each FPI or an investor group as referred in SEBI (FPI) Regulations, 2014, shall be less than 10% of the total paid-up equity capital on a fully diluted basis or less than 10 percent 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 shall not exceed 24% of paid-up equity capital on a fully diluted basis or paid up value of each series of debentures or preference shares or share warrants issued by an Indian company. The said limit of 10% and 24% will be called the individual and aggregate limit, respectively. And the aggregate limit of 24% can be increased by the Indian company concerned up to the sectoral cap/ statutory ceiling, as applicable, with the approval of its Board of Directors. It shall also get its shareholders' approval at General Body meeting through a special resolution.
2. If an FPI breaches the investment limits, it shall sell such capital instruments within 5 trading days, up on which such breach will not be treated as contravention under FEMA. For arriving at the ceiling on holdings of FPI, capital instruments acquired both through primary as well as secondary market will be included. However, the ceiling will not include investment made by the FPI through off-shore Funds, Global Depository Receipts and Euro-Convertible Bonds.
3. In case the total holding of an FPI increases to 10% thresholds provided above, the total investment made by the FPI shall be re-classified as FDI, at the option of such FPI, subject to the conditions as specified by SEBI and RBI in this regard, and the investee company and the investor shall comply with the reporting requirements prescribed in regulation 13 of FDI Regulations.
4. An FPI may purchase capital instruments of an Indian company through public offer/ private placement, subject to the individual and aggregate limits prescribed. And in case of public offer, the price of the shares to be issued is not less than the price at which shares are issued to residents, and in case of issue by private placement, the price is not less than the price arrived in terms of guidelines issued by SEBI or the fair price worked out as per any internationally accepted pricing methodology for valuation of shares on arm's length basis, duly certified by SEBI registered Merchant Banker or Chartered Accountant or a practicing Cost Accountant, as applicable.
5. An FPI may, undertake short selling as well as lending and borrowing of securities (SLBM) subject to below conditions:
 - a. The short selling of equity shares by FPIs is permitted for equity shares of those companies where there is at least 2% headroom available for total foreign investment and/or aggregate FPI limit and is not in the caution list or ban list published by RBI or any restrictive list published by any authority designated to do so by the RBI or SEBI.
 - b. Borrowing of equity shares by FPIs will only be for the purpose of delivery into short sale.

- c. The margin/ collateral will be maintained by FPIs only in the form of cash. No interest shall be paid to the FPI on such margin/ collateral.
- d. The designated custodian banks shall separately report all transactions pertaining to short selling of equity shares and lending and borrowing of equity shares by FPIs in their daily reporting with a suitable remark (short sold/ lent/ borrowed equity shares) for the purpose of monitoring by RBI.

Regulations governing investments in Securities other than Capital Instruments:

As per Regulation 5(5), an FPI can purchase or sell securities other than capital instruments ('Debt Securities') permitted by RBI in consultation with Central Government, in the manner and subject to conditions provided in Schedule 5. The list of instruments / securities provided in Schedule 5 are same as those approved under SEBI FPI Regulations (discussed in earlier paragraphs). RBI closely monitors the investments by FPI in Debt Securities, especially investments in Government Securities and Corporate Bonds, definitions of which are as follows:

Government Security means a security created and issued by the Government for the purpose of raising a public loan or for any other purpose as may be notified by the Government in the Official Gazette and having one of the forms namely government promissory note, bearer bond, stock or bond held in bond ledger.

Corporate Bonds and debentures mean non-convertible debt securities issued in India which create or acknowledge indebtedness, including (i) debentures (ii) bonds (iii) commercial papers (iv) certificate of deposits and such other securities of a company, a multilateral financial institution (MFI) or a body corporate constituted by or under a Central Act or a State Act, whether constituting a charge on the assets of the company or body corporate or not, but does not include debt securities issued by Central Government or a State Government, or such other persons as may be specified by the Reserve Bank, security receipts and securitized debt instruments.

As per Regulation 5(10) read with Schedule 10, FPIs are permitted to invest in Indian Depository Receipts (IDRs) subject to condition that such IDR shall not be redeemed in to underlying equity shares before the expiry of one year from the date of issue. The overall cap for investment by eligible foreign entities in Indian markets through issuance of IDRs shall be USD 5 Bn and shall be monitored by SEBI. Any conversion / redemption in to underlying equity shares of the issuing company shall comply with FEM (Transfer or Issue of any Foreign Security) Regulations, 2004 as amended from time. However, FEMA provisions shall not apply to the holding of the underlying shares, on redemption of IDRs by the FPIs.

RBI issues AP (DIR Series) Circulars from time to time through which it governs the FPI investments in Debt Securities. Below are relevant guidelines in this regard:

1. RBI decides monetary limits up to which FPI investments can be allowed in debt securities. Govt Securities includes those issued by Central Govt (CG Sec) and by State Govt (State Development Loans – 'SDL'). For the purpose of investments in Govt Securities, FPI Investors are classified as Long Term category which includes pension funds, insurance funds, foreign central banks etc., and General category.
2. The current monetary limits for CG Sec, SDL and Corporate Bonds are as below:

CG Sec – General	INR 2,23,300 Cr
CG Sec – Long Term	INR 92,300 Cr
SDL – General	INR 38,100 Cr

SDL – Long Ter	INR 7,100 Cr
Corporate Bonds	INR 2,89,100 Cr
Total	INR 6,49,900 Cr

3. Effective June 2014, FPIs were allowed to participate in currency futures and exchange traded currency options. RBI vide A.P. (DIR Series) Circular No. 18, dated Feb 26, 2018, fixed the cap of USD 100 Mn under this category for transactions across all currency pairs and it shall be cumulative for all exchanges (Previous limit was USD 10 Mn for USD-INR pair per exchange and USD 5 Mn for GBP-INR, SGD-INR, JPY-INR pairs put together per exchange).
4. Effective November 2015, FPIs were allowed to invest in non-convertible debentures and bonds of Indian companies which defaulted in payment of principal on maturity or principal instalment in case of amortized bonds by way of purchase from existing holders of such securities. However, the information with regard to such purchase offer should be intimated to concerned debenture trustee, and such investment should be within overall limits meant for corporate bonds.
5. RBI vide AP (DIR Series) Circular No. 31, dated June 15, 2018 has issued latest guidelines on debt instruments amending many previous circulars, as below:
 - a. There shall be no minimum maturity period for investments in CG Secs, including treasury bills and SDLs, subject to condition that investments in securities with less than one-year maturity shall not be more than 20% of total investments by FPI in that category. Previously minimum maturity period was of three years.
 - b. Coupon receipts by FPIs on their investments in govt securities is now part of total monetary limits allocated therefor. Previously it was outside such limits.
 - c. Minimum maturity period for investments in Corporate Bonds shall be one year (earlier three years). However, FPIs are permitted to make short term investment of less than one-year subject to condition that such investments shall not be more than 20% of total investments by FPI in corporate bonds.
 - d. Minimum maturity period is not applicable for investments in Security Receipts issued by Asset Reconstruction Companies
 - e. The requirement that short-term investments shall not exceed 20% of total investment by an FPI in any category applies on an end-of-day basis. At the end of any day, all investments with residual maturity of up to one year will be reckoned for the 20% limit.
 - f. Short-term investments by an FPI may exceed 20% of total investments mentioned above, only if the short-term investments consist entirely of investments made on or before April 27, 2018.
 - g. The cap on aggregate FPI investments in any CG Sec shall be 30% of the outstanding stock of that security. Previously this was capped at 20%.
 - h. Utilization limits of CG Sec and SDLs categories shall be monitored online by Clearing Corporation of India. Previously FPIs were permitted to invest up 90% of Govt Sec limits directly, and beyond that there used to be auction mechanism by stock exchanges. And usage was monitored by Depositories.
 - i. FPI investment in corporate bonds shall be subject to the following further requirements as below:
 1. Investment by any FPI, including investments by related FPIs, shall not exceed 50% of any issue of a corporate bond. In case an FPI, including related FPIs, has invested in more than 50% of any single issue, it shall not make further investments in that issue until this stipulation is met.

2. No FPI shall have an exposure of more than 20% of its corporate bond portfolio to a single corporate (including exposure to entities related to such corporate). In case an FPI has, as on April 27, 2018, exposure in excess of 20% to any corporate (including exposure to entities related to such corporate), it shall not make further investments in that corporate until this requirement is met. This condition is not applicable for new FPIs which are registered after April 27, 2018 for their investment in corporate bonds till March 31, 2019 or six months of incorporation whichever is earlier. Pipe-line investments, i.e., transactions that were under process but had not materialized as on April 27, 2018 , shall also be exempt from the 20% threshold limit, subject to the condition that major terms like price, tenor and amount of investment are agreed up on, and actual investment commences by December 21, 2018.
- j. No FPI shall invest in partly paid debt securities.
 - k. FPIs are also permitted to invest in REITs and InvITs.