Foreign Individual Investors Investments In Mutual Funds

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Current Investment Scenario – Foreign Investors

- Foreign corporations, funds or individuals who meet the criteria for registering as a FII or subaccount thereof, and who register with SEBI, are allowed to invest in the securities of an Indian company under the Portfolio Investment Scheme, subject to specified ceilings

Current Regulatory Scenario – Foreign Investors

- Separate regulation for different categories of investors (e.g. Foreign Institutional Investor, Foreign Venture Capital Investor and Non-Resident Indian) and sub-account holders
- Investments are regulated and/or monitored in turn by the RBI, SEBI, the Department of Industrial Policy and Promotion and the Ministry of Finance
- Presence of multiple regulators and multiple routes for channeling the same investment encourages creative structuring of investments to skirt the letter of the law
- Tarapore committee states that there should be a rationalisation/simplification of the regulatory system and procedures in a manner wherein there can be a viable and meaningful monitoring of these flows
- UK Sinha committee report of the working group of foreign investment addresses many of these concerns

UK Sinha Committee Report of The Working group of Foreign Investment

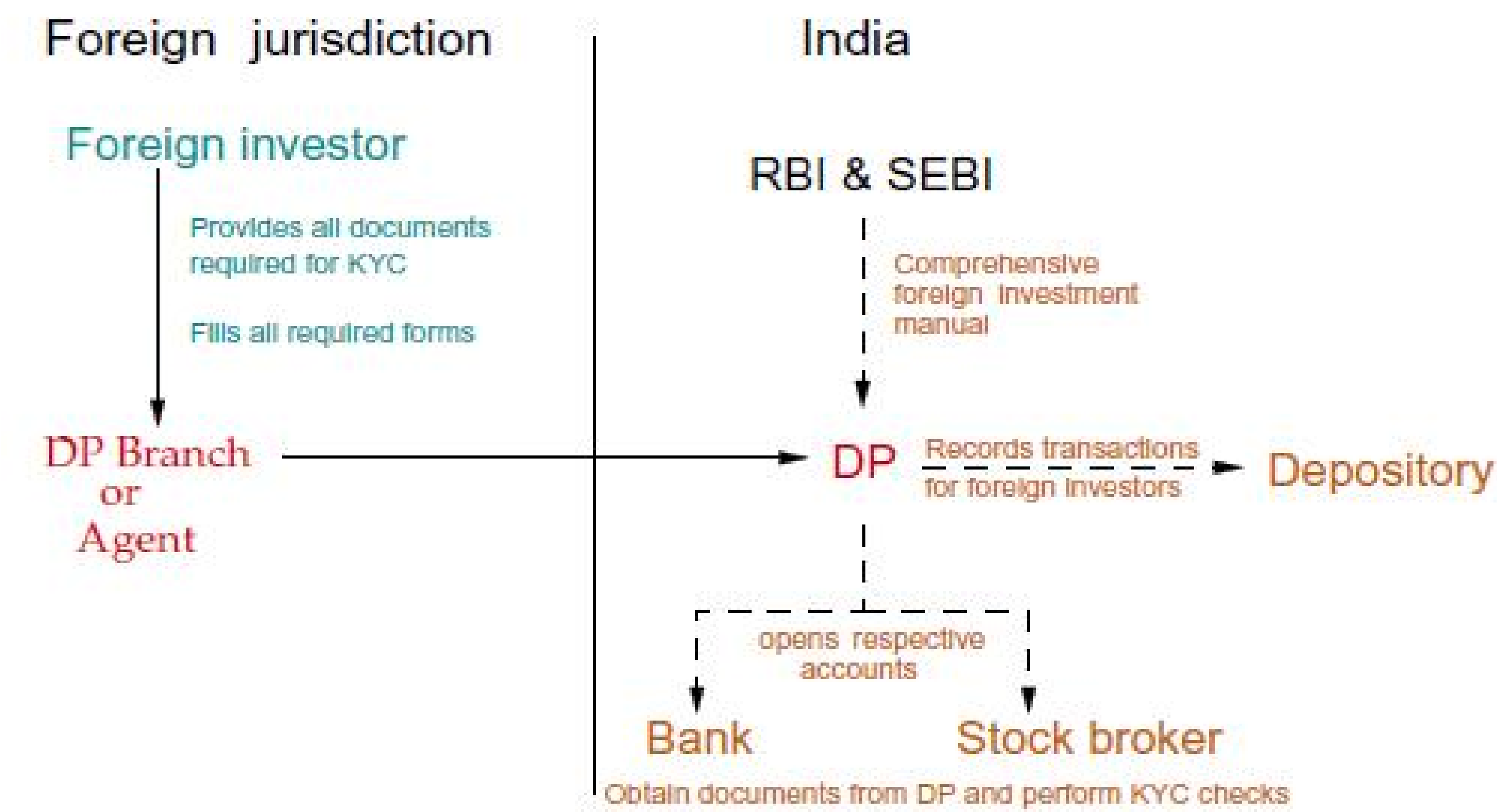
Single Window of Portfolio Investment

- Committee proposes a restructuring and rationalization of the administration of capital flows management regulations
- Committee recommends a single window for registration and administration for portfolio investment regulations with a new investor category called Qualified Foreign Investors (QFI)
- In such a framework, qualified depository participants ("DPs"), with global presence through branch network or agency relationships would be legally responsible for enforcing OECD-standard KYC requirements
- Such global DPs would have higher capital requirements and would need to pass a detailed fitness test administered by SEBI
- The Committee further suggested that FIIs, FVCIs and NRIs would be abolished as an investor class

Peer Comparison

- Brazil, South Africa, South Korea and Turkey do not fragment markets by differentiating between different types of investors
- Above countries follow OECD practices of distinguishing portfolio and direct investment where, namely, investment between zero and ten percent in a listed company is considered portfolio investment and investment over this amount is considered direct as recommended by the committee

Proposed QFI Framework



How Would QFI Work for Individual Investors ?

- The foreign entity approaches the office/branch of a Depository Participant regulated by Indian authorities ("DP") or the DP's agent in his home country, to open a QFI account
- The proposed QFI fills up forms and deposits all documents to fulfill KYC rules and other sets of information that different authorities may choose to collect
- The proposed QFI fills up forms and applications to open the following (along with the requisite documents):
  - An account with a DP
  - An account with a custodian
  - A QFI account with a bank regulated by RBI
  - An account with a SEBI registered broker to carry out instructions
- The DP then takes the relevant documents and opens the accounts for the foreign entity on his behalf

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- The foreign entity gets an unique number, perhaps a Personal Account Number or "PAN," which is kept by the DP which connects all the accounts opened by him and reports this number to SEBI, RBI, CBDT or any regulator as required
- The foreign entity is now ready to trade in the Indian Securities Market without ever setting foot in India

Legal Changes to Introduce QFI Category

- QFI
  - SEBI FVCI and FII regulations would be replaced by a new QFI regulation
  - FEMA (Transfer or Issue of Security by a Person Resident Outside India) Regulations, notably Regulation 5 and attendant schedules would have to restate permissible caps and investment levels, now unified across asset classes
  - Schedules specifying permitted investments by FIIs, FVCIs and NRIs would ostensibly be replaced by a new schedule for QFIs
- Depositary Participants
  - Enforcement of contracts between depository participants and investors should be clarified. In particular, international dispute settlement mechanisms should be established
  - SEBI (Depositories and Participants) Regulations, 1996 would have to be amended to allow DPs to set up offshore branches
  - FEMA (Transfer or Issue of Any Foreign Security) Regulations need to be amended to allow setting up of DPs abroad
  - SEBI (Stock Broker and Sub-Broker) Regulations, 1992 would have to be changed to allow stock brokers to register foreign investors as clients with SEBI
  - Criteria for filtering DPs who could be entrusted with the task of registering QFIs would have to be promulgated

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- KYC
  - KYC guidelines for depository participants would have to be adopted and dovetailed with AML-CFT frameworks including those for reporting suspicious transactions (“Suspicious Transaction Reports”). Issues of responsibility for analyzing and taking action on STRs would have to be clarified and responsibilities assigned
  - DPs would report KYC information on behalf of clients investing in unlisted equity directly to the RBI. The RBI, pursuant to Foreign Exchange Management (Deposit) Regulations, 2000, Regulation 5, Schedule 3 would also have to give approval for the opening of limited purpose accounts for securities transactions

Foreign Individual Investors Investing in Mutual Funds (MFs)

Current Scenario & Budget Announcement

- At present only FIIs and sub-accounts registered with SEBI and NRIs are allowed to invest in mutual fund units
- As per the recent budget announcement, Foreign Individual Investors would be permitted to invest in MFs subject to the investors meeting KYC norms for equity schemes

Will MF Industry Benefit From This Liberalisation ?

- As per data available with Value Research (article in Economic Times dated March 7, 2011) there are about 157 offshore funds on Indian securities which are available in all major financial markets with a total AUM of around USD 50 bn much higher than all domestic equity fund put together
- Approximately $20 bn offshore ETFs and around $10 bn of P-Notes (restricted) are invested in Indian equities
- Huge opportunity to be tapped, however concerns remain due to regulatory hurdles
- Would help Indian MFs align themselves with global standards
- Intangible benefits like global expertise and knowledge would be in addition to the above

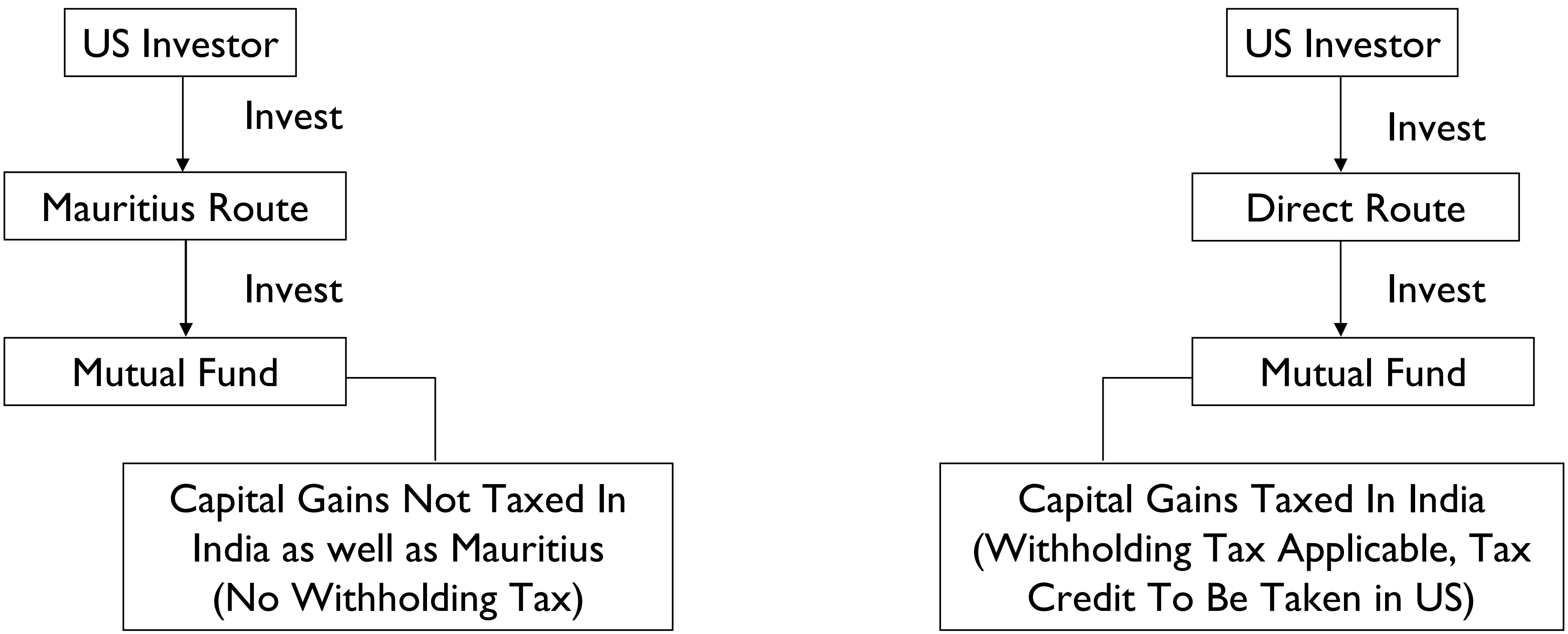
How Would MFs Benefit Due To QFI Introduction ?

- Global Depositary Participant (DP) would complete the KYC requirements
- Open ended funds listed on exchange can tap foreign investors through MFSS/BSE Star segment along with ETFs
- KYC requirements would be taken care by global DP - A Win Win... situation for both categories
- MFs would not have to go through the hassles of setting up offshore vehicle for marketing their products
- PMLA guidelines for suspicious transaction currently followed by MFs would already be complied by global DPs
- Hassles of PMLA guidelines for MF for adhering to risk perception including the Politically Exposed Person (PEP) of the clients in different countries would be gone
- Cost of compliance for MFs would reduce

Impediments

Option 1

Option 2



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- Foreign investor investing in Option 1 is at an advantage as compared to Option 2 due to
  - No withholding tax in India if invested through Mauritius route
  - No Capital Gains tax in Mauritius as it is a tax heaven
- In case of option 2 which entity (MF or the custodian) would deduct the withholding tax ??
- Foreign residents investing from countries with whom India has bilateral tax treaty are subject to no tax or favorable tax rate as compared to countries with whom India doesnot have bilateral tax treaty
- The capital loss incurred in the home country could not be set off against gain in the source country due to deduction of taxes in the source country
- Committee headed by Mr. U. K. Sinha, has recommended that Ministry of Finance should study the revenue implications for shifting to a residence based system of taxation from source based system

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- Peer countries like Brazil, South Korea and Turkey are already following residence based taxation
- SEBI should look at harmonizing Indian MF regulations with Global MF regulations (UCTIS iii)
- Similarly Indian regulator should consider allowing international funds to be marketed in India under $200000 window
- In some countries, ADRs/GDRs of Indian companies and derivatives of Indian Indices are available for trading. Investors who have access to this, would not like to trade in India due to bias to the home country

MF Industry Voices

"It's a good move because obviously there has been a fair bit of interest amongst foreign investors towards Indian markets, not just for the past year or so, but the past three to four years"

"At present, foreign investors have a limited number of India-dedicated funds to invest in India. This move will enable them to invest in Indian funds managed by Indian fund managers"

"It will take some time before it translates into inflows as distribution platforms need to be robust. We need to talk to foreign distributors and put our funds in their platforms. Initially, this will happen through online distribution platforms as people may not be too comfortable using fax and telephones"

"The move to allow foreign investors might provide the much required depth but at the same time MF might see a lot of volatility in the inflows/outflows leading to underperformance. It could also impact the other retail/institutional investors. Therefore, the modality of its implementation will need to be discussed before it is formalized"

Thank You