Print This Pa

FPI rules 2.0: Disruption or innovation? You decide

Divaspati Singh and Kaushiki Agarwal

The Securities and Exchange Board of India has gone the whole hog in revamping the FPI regime with the introduction of the Foreign Portfolio Investor Regulations, 2019. This followed relief in the form of rollback of the super-rich tax that had spooked foreign portfolio investors (FPIs).

As expected, these amendments speak of the same mandate that the H R Khan Committee was set up with: largely to simplify and streamline entry routes for FPIs and harmonise investment templates for foreign investors across the board while strengthening Indian financial markets.

The most pronounced of these changes is the streamlining of the erstwhile three categories of FPIs into just two -- Category I and Category II. Category I continues to include government and government-related investors, pension funds, university funds, and certain appropriately regulated entities from Financial Action Task Force (FATF) member countries. Category II is now the miscellaneous category that includes entities not eligible for registration as Category I FPIs such as certain funds from non-FATF member countries, endowments, foundations, charitable organisations, corporate bodies, family offices, and individuals.

Investment funds seeking Category I FPI registration are now required to be from the FATF bloc only, with certain exceptions as discussed below. This might leave various FPIs set up in Mauritius and the Cayman Islands investing in India in a sticky situation. While Mauritius and Cayman Islands are part of regional unions (the Eastern and Southern Africa Anti-Money Laundering Group and the Caribbean Financial Action Task Force, respectively) that are associate members of the FATF, it is unlikely that such indirect affiliation with the FATF will satisfy this jurisdiction-related criteria set out by SEBI.

There are numerous fund structures established in non-FATF member jurisdictions by participants across the globe, who may now qualify under the residual category, i.e. Category II.

Such funds from the non-FATF jurisdiction may qualify for Category I registration. But the conditions are: Either their investment manager is from the FATF grouping and is registered as a Category I FPI, or a single investor holding 75 percent or more in the fund is an FATF member country. In either case, the investment manager or the significant investor is willing to undertake all obligations and liability for compliance of such fund.

While this relaxation does bring relief, it will continue to be problematic for funds from non-FATF members investing in India that are broad-based and/or do not have a single investor hailing from the FATF that holds at least 75 percent in such offshore funds, or where such investor is an independent third party investor who may not be willing to take on such obligation. Such funds may qualify as Category II FPIs.

Notably, Category II FPIs may not be riddled with certain obstacles the erstwhile Category III FPIs were subjected to. Under the previous set-up, the latter faced certain disadvantages like the ineligibility to participate in qualified institutional placements, being anchor investors for primary issuances, restrictions on issuance, subscription or dealings in offshore derivate instruments, and the levy of capital gains tax on the transfer of units if Indian assets constituted a majority of their portfolio.

All FPIs other than individuals, corporate bodies and family offices, irrespective of categorization, have now been placed on par in respect of primary issuances and qualified institutional placements.

We await clarity on the road ahead from the tax department. If the current tax structure endures the changes to the FPI regime, Category II FPIs will be on the same footing as Category I FPIs in relation to indirect transfer tax benefits. With the transition, investment funds set up in the non-FATF jurisdiction that do not qualify for the Category I FPI licence may see a significant challenge in subscribing to offshore derivative instruments.

Another noteworthy consideration for structuring fund setups is the relaxation provided to entities established in International Financial Services Centres (IFSCs) (for example, GIFT City), which will be deemed to be appropriately regulated under the FPI regime.

Therefore, such IFSC funds won’t have to separately comply with the FATF jurisdiction criteria. Setting up funds in IFSCs could be a route worth exploring, particularly for investors from non-FATF member jurisdictions, in addition to the already inviting tax benefits accorded to IFSC entities.

Furthermore, SEBI has got rid of the broad basing requirement for FPIs. Foreign investors are no longer required to have a minimum number of investors or a maximum cap on the shareholding of individual investors in the FPI entity to qualify as Category I. This will certainly hasten the entire registration process since depository participants will no longer need to ensure compliance with the broad based criteria, and it will certainly accord Category I status to funds that otherwise qualify for the jurisdiction criteria.

Having spoken about the conspicuous changes, we turn to the latent incentives offered by SEBI in the form of these regulations. For instance, the investment limit available to FPIs has now been changed to 10 percent of the fully diluted equity capital of a company (as against the previous 10 percent which was of the paid-up equity capital).

This increases headroom for investments by FPIs in the equity of companies. With the focus on KYC, the ultimate beneficial ownership details of all entities proposing to register as FPIs has become mandatory, and hence, the earlier limitations on certain kinds of structures such as ‘protected cell companies’ or ‘segregated portfolio companies’ has been done away with, and they can now seek registration as FPIs for investments in India.

Additionally, FPIs can now engage in off-market transfer of rights entitlements, and illiquid, delisted or suspended securities as well. All unlisted securities received by FPIs pursuant to a debt resolution scheme of any Indian entity will be treated as foreign direct investments (FDI). This is something that FPIs with a distressed debt outlook should be mindful of, given that they could receive such securities on account of any debt conversions and be treated as a foreign direct investor for the purposes of such investment.

With these changes, SEBI seems to have done its bit to create a favourable environment for FPIs. While most changes by SEBI are very welcome, they will have to be assessed in light of the current fund structures and of course, the operational guidelines which are still awaited, to get a holistic picture.

The only way to sustain stable investment flows is through a level of regulatory, legal and tax certainty. In coming days, once the operating guidelines are released, we hope that SEBI will allow existing FPIs to smoothly transition to the new regime, without taking away their current benefits or flexibilities, while leaving the structures already established in offshore non-FATF member jurisdictions intact.

Divaspati Singh is a partner and Kaushiki Agarwal an associate at law firm Khaitan & Co. Views are personal.