QFI in India

V.K.Bansal
Managing Director, Chairman of India Investment Banking Morgan Stanley India Co.Pvt.Ltd.

Introduction

Economic growth is driven by the three key economic inputs - viz. Labour, Technology and Capital. In India's case, the favourable demographics ensured that India had sufficient labour since the country's inception. Post liberalization in the early 1990s, India opened its gates to both technology and capital from abroad. This massive inflow of capital and technology from abroad coupled with the strong dry powder of labour created a potent growth mix which led to an explosive growth in the Indian economy.

In India, the key channels for capital inflow have been the Foreign Direct Investments (FDI) and Portfolio Investment Scheme (PIS) routes. PIS includes investment by Foreign Institutional Investors (FII) and Non-Resident Indians (NRI). FDI allows investment into operating or investing companies but disallows any acquisition on the stock exchanges. FDI is regulated by RBI and the FDI policy of the Government. FDI investments are also constrained by the sectoral limits as per the Government's FDI policy. On the other hand the PIS route allowed only the FIIs registered with SEBI and NRIs to participate through the stock markets and public offerings. So the only option for foreign investors to participate in Indian stock markets was FII route which was heavily regulated by SEBI or through Participatory-notes (P-notes) issued by FIIs.

Several economists have argued that for a capital lacking country like India to grow, the balance of capital inflow should be tilted towards FDI than FII. China is considered by many as a case in point. The underlying argument is that FDI into the country leads to creation of assets and is directly mapped to income generation. Also since it cannot leave the country easily, FDI is considered to be a less volatile source of capital.

Whatever the route, there has been significant acceptance within the country and its leaders that foreign capital is necessary for India to fuel its high speed growth ambitions. This recognition has led to the government relaxing capital control norms and creating multiple routes for foreign capital to enter India. The SEBI Foreign Institutional Investors (FII) Regulations, 1995 was a key step in this direction. This regulation saw an influx of capital from foreign institutional investors across the globe in to Indian capital markets. Further refinements and fine tuning has happened in the process across the years.

Background to the QFI Framework Evolution

These considerations led to the government setting up a 'Working Group on Foreign Investment'. This group consisted of eminent persona from the Indian financial and administrative world was led by the current SEBI Chairman Shri U K Sinha. The working group advised on the formulation of a 'Single Window for Portfolio Investment in India' called Qualified Foreign Investor (QFI).

The QFI route was prepared as a means to combine several existing routes including FII route, NRI investment route and FVCI (Foreign Venture Capital Investor) route, and provide a single window, investor friendly route for portfolio investment across all investor class. This framework was originally developed by studying the practise in countries like Brazil, South Korea, South Africa and Turkey. The aim of the framework developed was to 'replace the existing system of multiple investor class that gives opportunities for regulatory arbitrage'.

Another key objective of the route was to expand the possible foreign investor segments who could invest into India. The FDI and FII routes serve different purposes and have addressed a large chunk of the foreign investor community. To capitalize on the potential latent demand of retail investors abroad, the QFI route permitted participation by retail investors from select nations. The QFI route was first introduced for investment into Indian mutual funds and was subsequently enhanced to allow investment into listed equities and corporate debt. As the framework gradually evolved, the key highlight of the framework also moved from 'being the single window for portfolio investment' to a route which will induce the latent retail investor demand from select nations including USA, UK, Hong Kong, Middle East and Singapore.

Brief Overview of the SEBI QFI Framework

QFI in its current form provides for equity, corporate debt or mutual fund investments by a

- Resident in a country that is a member of Financial Action Task Force (FATF) or a member of a group which is a member of FATF
- Resident in a country that is a signatory to IOSCO's MMOU (Appendix A Signatories) or a signatory of a bilateral MOU with SEBI

The investor typically can be a foreign national, family office, pension fund, hedge fund, corporate, etc. but the person should not be a resident in India nor registered with the SEBI as a Foreign Institutional Investor or a sub-account holder or a Foreign Venture Capital Investor. Unlike FIIs, QFIs do not require any lengthy and difficult regulatory registration with SEBI or RBI for market access. QFIs will have to create a Depository Participant (DP) account with a Qualified Depository Participant (QDP) and follow some simple KYC procedures. One of the requirements from a tax perspective is to obtain a Permanent Account Number (PAN).

There are two limits applicable to equity holding in a company by QFIs:

- Shareholding of an individual QFI cannot exceed 5% of the paid up equity capital of the company at any point of time
- Aggregate shareholding of all QFIs cannot exceed 10% of the paid up equity capital of the company at any point of time

In case this limit is exceeded, the QFI due to whom the limit is breached shall mandatorily divest excess holdings within three working days of such breach being notified by QDPs to the DP. Other restrictions are the possible instruments to invest in - QFIs are not allowed to invest in derivatives or in offshore derivative instruments. The QFI investment route cannot be used to bypass FIIs and issue P-notes or any such off shore derivatives.

QFI vs. FII: A Comparative Summary

	Qualified Foreign Investor ("QFI")	Foreign Institutional Investor ("FII")
Eligibility	• Open to all category of investors — Retail and Institutional • No track record required • Only investors from jurisdictions which are FATF compliant and signatory to MMOU of IOSCO • Popular jurisdictions like Mauritius/Cayman not eligible	• Route open to specified categories of institutional and retail investors, meeting the pre defined conditions • One year track record prior to seeking registration as FII • FII from jurisdictions whose local Securities regulator is an Ordinary/Associate member of IOSCO • Sub Accounts can be from any jurisdiction
Registration	• No SEBI registration required • No market access regulatory fees	• Obtain registration with SEBI under defined categories • Registration fees of US$ 5,000 (for FII) and US$ 1,000 (for sub account), additionally payable every 3 years
Permitted Investments	• Equity and mutual fund schemes	• Equity, debt, listed derivatives, MFs, Interest Rate Futures, etc.
Account Structure	• A single securities account • No cash account permitted	• A single securities account • Permitted to open both local and foreign currency cash accounts
Clearing and Settlement	• Client to place trade orders to brokers through the QDP • DVP settlement between QDP and broker	• Client to place trade orders directly with the stock broker • Clearing and settlement of trades done by the local Custodian

Investment Limits/ Restrictions	• Up to 5% of the paid up capital of the company • Aggregate QFI investment limit of 10% • QFIs cannot issue ODIs	• Up to 10% (5% for foreign individual and corporate) of the paid up capital of a Company • Aggregate FII investment limit of 24% (extendable) • FIIs can issue ODIs (subaccounts can't issue ODIs)
Tax	• QDP/Mutual Fund to deduct applicable Income Taxes prior to repatriation/redemption	• Computation of Income Tax by FII appointed CPA
Foreign Exchange	• To & fro movement of fund from the QFI's designated overseas bank account to the QDP's account • Funds to be invested/re-invested within 5 days of receipt by the QDP	• No specified investment/Repatriation period for funds • FX hedging of portfolio through Forwards permitted

Comparison with Other Nations

Several nations do not impose any quantitative restrictions on foreign investment in the manner that India does. A peer set of Brazil, South Korea, South Africa and Turkey (which was the peer set originally used by the Working Group on Foreign Investment) do not differentiate between types of investors. Developed markets like US and UK allow non-residents from select nations to open brokerage account. The standard OECD practise of using a threshold of 10% stake in listed companies is used by the peer set for distinguishing portfolio investment from direct investment. The regulatory framework for most countries continues to be same in case of portfolio investment or direct investment unlike in India, where there are different regulators and rules for portfolio investment and direct investment. Investment in structured products like futures and forwards are also allowed by the peer nations for foreign nationals without any limits on positions. Another key differential is the taxation regime, which is resident based in several nations, while it is source based in India.

Key Highlights and Key Issues

While the QFI route permits investor classes ranging from retail individuals to corporates, the key segments that are expected to use this route are High Networth Individuals (HNIs) and Family trust offices. To make all relevant segments aware of the new route and to address any concerns raised by potential investors, the Government of India has decided to undertake a series of road shows with the help of Qualified Depository Participants (QDP). The recent road shows conducted by the Government of India in the Middle East have reported good participation and interest. Another interesting aspect of QFIs is that they can participate in the Offer for Sale (OFS) programme which was recently introduced by the Government of India to enable promoters whose holdings in listed companies are in excess of the listing agreement's minimum float requirement, to bring down their stake.

The key concerns that were reported includes the detailed documentation requirements of KYC and requirement of annual filing in case of PAN card. Areas of concern within the KYC documentation includes the sharing of personal identification proof like passport copy and providing substantial information regarding ultimate beneficial ownership of the QFI investor. Personal verification is another KYC requirement that is considered as 'non investor friendly'. Tax clarifications related to corporate debt investments via QFI route are also pending.

Till date, the Government of India has been highly accommodating and understanding, and based on some of the concerns of investors, have proactively relaxed select clauses (e.g.: The increase in number of days the money can be held before repatriation has been increased from 2 days to 5 days and the scope of the allowed investment class has been expanded to include equity and corporate debt as well). The Government is also reported to have plans to introduce one single form for both KYC and PAN card application to streamline the process of opening new QFI investor accounts. On the other hand, the Government has stuck to its stand of not allowing any opaque holding structures for the QFIs and has refused to do away with the PAN requirements. Another issue being debated is that the current QFI KYC requirements are 'rule based', and instead should be more 'principle based'. For example, in a principle based regulation, the QDP is guided by principles to ensure that proper diligence and care has been

carried out to ensure compliance of all regulations by the QFI. Here the QDP would have the freedom to decide what amount of KYC information is to be obtained from each QFI. The QDP's focus will be on the outcome (i.e. to ensure that no violation of regulations happen, based on the principles) and shall be free to select the required steps to achieve this end outcome. Since the debate between 'rule based' and 'principle based' regulation is a very diverse and broad topic, we will not delve into its discussion in this article.

Taxation in the recent times has caused a lot of concerns to the foreign investor community and the requirement of PAN and an annual tax filing are not viewed favourably. It has been reported that the government may do away with the requirement of annual filing for QFIs, and since the process of PAN card creation is only expected to take 2 weeks, the investors could get comfortable with this requirement as well.

Another key question that is in everyone's mind is whether QFI will replace P-notes as an investment route. The fact that most P-note investors take structured positions (including future & options) and may have potential tax advantages (subject to GAAR clarifications) versus the QFI route makes one believe that P-note investor may not look at QFI as an alternative, in its current form.

Regulation in this route will be closer to the Indian retail investor regulation that the method of FII regulation. Effectively, the QDP is responsible for ensuring that the QFI is following all regulations and has complied with the KYC and AML requirements as per the SEBI Master Circular on AML/ CFT. The Qualified Depository Participant (QDP) is clearly the key element who will deal with the regulators. This is a key feature as the end investor does not have to go through the hassles of registering and dealing with the regulators and the regulator has to only deal with the licensed QDPs who are entrusted with ensuring all the regulatory requirements are met. This may attract investors who are more comfortable to deal with regulators through QDPs than directly.

The lack of QFI transactions till date should not be treated as a serious issue as the framework is still evolving and the investors are still having several queries that require to be addressed. The QDPs have also reported that several investors are in touch with them and some have initiated the account opening procedures as well. Once the KYC and PAN process related issues have been ironed out and all tax related matters have been settled, we should see a slow but growing influx of retail investors (especially the HNI and Family trust office categories) through this route.

Summary

The QFI route is a highly exciting introduction by the SEBI to tap foreign retail investor demand and has immense future potential to serve as the 'single window single channel for portfolio investments into India'. While these are early days, and the framework is slowly evolving, the pro-activity and willingness shown by various stakeholders is highly encouraging. The QDP community also continue to actively engage and educate potential investors. We see these as encouraging signs and believe that the commitment of the stakeholders will enable this route to flourish in the future. In the near term, the onus is on the Government and the QDPs to ensure that all investor concerns and road blocks are worked around, to ensure that the current investor enthusiasm is converted to actual accounts and transactions.