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SEBI simplifies, rationalises FPI Regulations

SEBI has introduced significant changes to the FPI regulatory framework primarily aimed at easing the registration process, removing redundant regulatory conditions and reducing the compliance requirements

Background:

The Securities and Exchange Board of India (SEBI) notified the revised Foreign Portfolio Investor (FPI) Regulations on 23 September 2019. These regulations are referred to as SEBI (FPI) Regulations 2019 (revised regulations) and have replaced the SEBI (FPI) Regulations, 2014 (erstwhile regulations).

In March 2018, SEBI had set up a working group to review the regulatory framework for FPIs in India with the objective to rationalise and simplify the regime. The working group was headed by Mr. H.R. Khan (Ex-Deputy Governor of Reserve Bank of India) and consisted of SEBI officials, four large custodian banks, two CPA firms (one of which was Deloitte) and two law firms. The working group submitted its recommendations in May 2019 which were released for public comments. SEBI has now released the final regulations which are largely in line with the recommendations of the working group and also consider many of the public comments.

Key changes:

The key changes as compared to the erstwhile regulations are as follows:

- **Re-categorisation of FPIs:** The erstwhile three categories of FPIs have been merged into two and category III has been done away. Accordingly, FPIs will now be classified as Category I or Category II. Also, the list of entities eligible for Category I registration has been expanded to include certain regulated funds which could earlier register either under Category II or Category III.

The below mentioned entities (which were hitherto registered as Category II FPIs) will now be eligible to register as Category I FPIs:

- (a) Pension funds and university funds
- (b) Regulated¹ entities including insurance or re-insurance entities, banks, asset management companies, investment managers, investment advisors, portfolio managers, portfolio managers, broker dealers and swap dealers
- (c) The following entities set up in Financial Action Task Force (FATF) member countries²:
 - Regulated funds
 - Unregulated funds whose investment manager(IM)³ is regulated and registered as a Category I FPI
 - Endowments of a university which has been in existence for more than 5 years

¹ Regulated by securities market regulator or banking regulator of home jurisdiction or otherwise in the same capacity in which it proposes to invest in India

² <https://www.fatf-gafi.org/about/membersandobservers/>

³ An entity performing the role of investment management or any equivalent role including trustee(s)

- (d) Any entity whose IM is from a FATF member country and such IM is registered in India as a Category I FPI
- (e) Any other entity which is at least 75 percent owned directly or indirectly by an entity referred in (a) to (c) above provided the entity which owns at least 75 percent ownership in the FPI is from a FATF member country

Also, all the funds / entities presently registered as Category III FPIs would be upgraded to Category II FPIs.

Please refer to the Annexure for the list of entities eligible for Category I and Category II registration under the revised regulations.

Impact: The re-categorisation is likely to provide significant relief to FPIs primarily from the perspective of KYC requirements. Also, there would likely be certain other consequential reliefs accruing to existing Category III FPIs from the upgradation as discussed below:

- (a) **Non-applicability of indirect share transfer provisions:** Under the Indian Income Tax law, transfer of shares or interest in a Category III FPI outside India could be subject to Indian capital gains tax if Indian assets account for more than 50 percent of the global assets of the FPI and certain other conditions are satisfied. Since Category I and Category II FPIs have been specifically exempted from the indirect share transfer provisions under the tax law, this exemption should also be available to the existing Category III FPIs.
- (b) **Eligible to qualify as QIBs:** Under the SEBI (ICDR⁴) Regulations, 2018, Category III FPIs do not qualify as Qualified Institutional Buyers (QIBs). As a consequence, they are neither eligible for investing in the Qualified Institutional Placements, nor are they permitted to invest as anchor investors in primary issuances by Indian companies. Such FPIs would now qualify as QIBs under the ICDR regulations.
- (c) **Higher position limits in derivatives:** Existing Category III FPIs would qualify for higher position limits as available to Category II FPIs presently.
- (d) **Lower KYC requirements:** Existing Category III FPIs would qualify for lower KYC requirements as available to Category II FPIs.

Note: It is likely that some of the potential advantages discussed above may not be extended to individuals, family offices and corporate bodies even after their re-categorisation. Further, the advantages would be subject to any new restrictions imposed on Category II FPIs under the income tax law or the relevant SEBI regulations.

- **Removal of broad based criteria:** Broad basing requirement has been completely done away with in the revised regulations. In the erstwhile regulations, broad-basing was one of the key requirements to obtain a Category II registration. A fund was regarded as a broad based fund if it had at least 20 investors (directly or on a look through basis) with no investor holding more than 49 percent shares of the fund. Alternatively, the fund could be deemed as a broad based fund if more than 50 percent ownership in the fund was held either by a bank, sovereign wealth fund, insurance / re-insurance company or a pension fund.

Impact: The removal of broad based criteria will provide significant relief not only to newly set up funds but also to existing funds as discussed below:

- a) Regulated non-broad based funds would be eligible for Category I registration provided they are set up in FATF member countries

⁴ Issue of Capital and Disclosure Requirements

- b) The categorisation of an FPI will now be based purely on its regulated status and its country of residence and not on the basis of number of investors in the fund
 - c) All the declarations and undertakings associated with broad based regulation will no longer be required
 - d) All the ongoing compliances related to broad based regulation (e.g. tracking of number of investors in the fund, re-categorisation of FPIs if the number of investors exceed /fall below 20) will no longer be required.
- **ODIs restricted to Category I FPIs:** In the revised regulations, Offshore Derivative Instruments (ODIs) such as Participatory Notes or Total Return Swaps can only be issued by Category I FPIs. Also, ODIs can only be issued to such entities which are eligible for registration as Category I FPIs.
Impact: Regulated funds which are not from a FATF member country and whose IM is not registered in India as a Category I FPI will not be able to issue or subscribe to ODIs. This could include funds regulated in Cayman Islands, Mauritius or Taiwan.
 - **Removal of opaque structure condition:** In the erstwhile framework, Designated Depository Participants (DDPs) were required to ensure that FPIs do not have an opaque structure. An Opaque structure was broadly defined to include entities with structures such as protected cell company, segregated portfolio company, etc. where the ultimate beneficial owners were not accessible or where the beneficial owners were ring fenced from each other or ring fenced with regard to enforcement. This condition is generally considered to be complex by FPIs given the confidentiality and other laws prevalent in different countries.
Considering that FPIs are required to provide information on their beneficial owners (pursuant to SEBI KYC circular dated September 21, 2018) both on ownership as well as control basis, the opaque structure condition has been removed in the amended regulations.
Impact: Removal of opaque structure condition will result in reducing redundant regulatory conditions and therefore simplify the compliance framework.
 - **Entities set up in IFSC eligible for registration as FPIs:** A fund / entity set up in an Indian International Financial Services Center (IFSC) will now qualify to register as an FPI even though such entity would be a domestic entity.
Impact: Investment managers (desirous of making investments in India under the FPI route) will now have an option to set up the fund in the GIFT City (India's first IFSC) instead of setting up the fund in an offshore jurisdiction. The Indian government has provided many direct and indirect tax incentives for entities to set up in IFSC.
 - **Revision in registration fees:** FPI registration fees (payable to SEBI) has been revised to US\$ 3,000 for Category I FPIs and US\$ 300 for Category II FPIs as against nil for Category I FPIs and US\$ 3000 for Category II FPIs in the past. The registration fee would not be payable by international or multilateral agencies such as World Bank and other institutions eligible for privileges or immunities from payment of tax and duties.
Impact: FPIs registered after the date of notification of the revised regulations will be required to pay revised fees. For existing FPIs, it is expected that the Operating Guidelines will provide clarity as to whether the revised fees would be payable only at the end of the three year period for which fees has been paid.

- **Others:** The other notable revisions in the regulations are as follows:
 - **Non-BIS member central banks permitted to register as FPIs:** Any foreign central bank can now register in India even if it is not a member of Bank for International Settlements (BIS). In the erstwhile regulations, any bank (including a central bank) could register as an FPI only if it was a resident of a country whose central bank is a member of BIS.
 - **Offshore funds set up by Indian mutual funds to register as FPIs:** With the view to prescribe a common investment regime for foreign portfolio investments in India, existing offshore funds set up by Indian mutual fund houses will need to register themselves as FPIs by 22 March 2020.
 - **Deemed surrender of FPI registration on non-payment of fees:** If an FPI does not pay the required SEBI fees for continuance of its FPI registration after a block of three years and there are no securities position or cash balance held by the FPI, it would be deemed that the FPI has surrendered its FPI registration in India. Accordingly, the DDP will proceed for surrender of registration after obtaining SEBI's approval.

Our comments: The amendments in FPI regulations would make the regulatory framework simpler and easier. The re-categorisation of FPIs would take away certain KYC and other restrictions faced by Category III FPIs and many of the existing Category II FPIs (including pension funds, university funds, regulated entities, funds based in FATF member countries) will benefit from the upgradation of their registration from Category II to Category I. The removal of broad based criteria would not only reduce compliance burden, but also encourage many funds to directly invest in India instead of indirectly accessing Indian markets through various offshore routes.

It is expected that SEBI will soon issue operating guidelines which will assist in operationalization of the amended regulations. The operating guidelines are likely to consolidate the circulars, clarifications and FAQs issued by SEBI since the introduction of SEBI (FPI) Regulations, 2014. The key aspects likely to be covered in the operating guidelines include revised KYC requirements post re-categorisation of FPIs, investment by private banks on behalf of their clients, modifications in the offshore derivative instruments (ODI) framework etc.

Annexure

FPI categories under revised FPI Regulations

- **"Category I foreign portfolio investor"** shall include–
 - government and government related investors such as central banks, sovereign wealth funds, international or multilateral organisations or agencies including entities controlled or at least 75 percent directly or indirectly owned by such Government and Government related investor(s);
 - pension funds and university funds;
 - appropriately regulated entities such as insurance or reinsurance entities, banks, asset management companies, investment managers, investment advisors, portfolio managers, broker dealers and swap dealers;
 - entities from the Financial Action Task Force member countries which are–
 - appropriately regulated funds;
 - unregulated funds whose investment manager is appropriately regulated and registered as a Category I foreign portfolio investor:
 - Provided that the investment manager undertakes the responsibility of all the acts of commission or omission of such unregulated fund;
 - university related endowments of such universities that have been in existence for more than five years;
 - an entity (A) whose investment manager is from the Financial Action Task Force member country and such an investment manager is registered as a Category I foreign portfolio investor; or (B) which is at least 75 percent owned, directly or indirectly by another entity, eligible under sub-clause (ii), (iii) and (iv) of clause (a) of this regulation and such an eligible entity is from a Financial Action Task Force member country:
 - Provided that such an investment manager or eligible entity undertakes the responsibility of all the acts of commission or omission of the applicants seeking registration under this sub-clause.
- **"Category II foreign portfolio investor"** shall include all the investors not eligible under Category I foreign portfolio investors such as–
 - appropriately regulated funds not eligible as Category-I foreign portfolio investor;
 - endowments and foundations;
 - charitable organisations;
 - corporate bodies;
 - family offices;
 - individuals;
 - appropriately regulated entities investing on behalf of their client, as per conditions specified by the Board from time to time;
 - unregulated funds in the form of limited partnerships and trusts;

Explanation: An FPI applicant incorporated or established in an International Financial Services Centre shall be deemed to be appropriately regulated.



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