Chapter-2

FOREIGN INSTITUTIONAL INVESTORS IN INDIA: AN OVERVIEW
Foreign investment refers to the investments made by the residents of a country in the financial assets and production process of another country.

The foreign investment is necessary for all developing nation as well as developed nation but it may differ from country to country. The developing economies are in a most need of these foreign investments for boosting up the entire development of the nation in productivity of the labour, machinery etc. The foreign investment or foreign capital helps to build up the foreign exchange reserves needed to meet trade deficit or we can say that foreign investment provides a channel through which developing countries gain access to foreign capital which is needed most for the development of the nations in the area of industry, telecom, agriculture, IT etc. The foreign investment also affects on the recipient country like it affects on its factor productivity as well as affects on balance of payments. Foreign investment can come in two forms: foreign direct investment and foreign institutional investment.

Foreign direct investment involves in direct production activities and in a long and medium term nature. As far as the FIIs concern it is the short term nature and short term investments. FIIs invest in financial markets such as money markets, stock markets and foreign exchange markets.

**Introduction to Foreign Institutional Investors (FII’s)**

Since 1990-91, the Government of India embarked on liberalization and economic reforms with a view of bringing about rapid and substantial economic growth and move towards globalization of the economy. As a part of the reforms process, the Government under its New Industrial Policy revamped its foreign investment policy recognizing the growing importance of foreign direct investment as an instrument of
technology transfer, augmentation of foreign exchange reserves and globalization of the Indian economy. Simultaneously, the Government, for the first time, permitted portfolio investments from abroad by foreign institutional investors in the Indian capital market. The entry of FIIs seems to be a follow up of the recommendation of the Narsimhan Committee Report on Financial System. While recommending their entry, the Committee, however did not elaborate on the objectives of the suggested policy. The committee only suggested that the capital market should be gradually opened up to foreign portfolio investments.

From September 14, 1992 with suitable restrictions, Foreign Institutional Investors were permitted to invest in all the securities traded on the primary and secondary markets, including shares, debentures and warrants issued by companies which were listed or were to be listed on the Stock Exchanges in India. While presenting the Budget for 1992-93, the then Finance Minister Dr. Manmohan Singh had announced a proposal to allow reputed foreign investors, such as Pension Funds etc., to invest in Indian capital market.

**Market design in India for foreign institutional investors**

Foreign Institutional Investors means an institution established or incorporated outside India which proposes to make investment in India in securities. A Working Group for Streamlining of the Procedures relating to Foreign Institutional Investors, constituted in April, 2003, inter alia, recommended streamlining of SEBI registration procedure, and suggested that dual approval process of SEBI and RBI be changed to a single approval process of SEBI. This recommendation was implemented in December 2003.
Currently, entities eligible to invest under the FII route are as follows:

- **As FII:** Overseas pension funds, mutual funds, investment trust, asset management company, nominee company, bank, institutional portfolio manager, university funds, endowments, foundations, charitable trusts, charitable societies, a trustee or power of attorney holder incorporated or established outside India proposing to make proprietary investments or with no single investor holding more than 10 per cent of the shares or units of the fund.

- **As Sub-accounts:** The sub account is generally the underlying fund on whose behalf the FII invests. The following entities are eligible to be registered as sub-accounts, viz. partnership firms, private company, public company, pension fund, investment trust, and individuals.

FIIs registered with SEBI fall under the following categories:

- **Regular FIIs** - those who are required to invest not less than 70% of their investment in equity-related instruments and 30% in non-equity instruments.

- **100% debt-fund FIIs** - those who are permitted to invest only in debt instruments.

The Government guidelines for FII of 1992 allowed, inter-alia, entities such as asset management companies, nominee companies and incorporated/institutional portfolio managers or their power of attorney holders (providing discretionary and non-discretionary portfolio management services) to be registered as Foreign Institutional Investors. While the guidelines did not have a specific provision.
regarding clients, in the application form the details of clients on whose behalf investments were being made were sought.

While granting registration to the FII, permission was also granted for making investments in the names of such clients. Asset management companies/portfolio managers are basically in the business of managing funds and investing them on behalf of their funds/clients. Hence, the intention of the guidelines was to allow these categories of investors to invest funds in India on behalf of their ‘clients’. These ‘clients’ later came to be known as sub-accounts. The broad strategy consisted of having a wide variety of clients, including individuals, intermediated through institutional investors, who would be registered as FIIs in India. FIIs are eligible to purchase shares and convertible debentures issued by Indian companies under the Portfolio Investment Scheme.

**Registration Process of FIIs**

A FII is required to obtain a certificate by SEBI for dealing in securities. SEBI grants the certificate SEBI by taking into account the following criteria:

i) The applicant's track record, professional competence, financial soundness, experience, general reputation of fairness and integrity.

ii) Whether the applicant is regulated by an appropriate foreign regulatory authority.

iii) Whether the applicant has been granted permission under the provisions of the Foreign Exchange Regulation Act, 1973 (46 of 1973) by the Reserve Bank of India for making investments in India as a Foreign Institutional Investor.
iv) Whether the applicant is a) an institution established or incorporated outside India as a pension fund, mutual fund, investment trust, insurance company or reinsurance company.
    (b) an International or Multilateral Organization or an agency thereof or a Foreign Governmental Agency or a Foreign Central Bank. (c) an asset management company, investment manager or advisor, nominee company, bank or institutional portfolio manager, established or incorporated outside India and proposing to make investments in India on behalf of broad based funds and its proprietary funds in if any or (d) university fund, endowments, foundations or charitable trusts or charitable societies.

v) Whether the grant of certificate to the applicant is in the interest of the development of the securities market.

vi) Whether the applicant is a fit and proper person.

The SEBI's initial registration is valid for a period of three years from the date of its grant of renewal.

**Investment Conditions and Restrictions for FIIIs:**

A Foreign Institutional Investor may invest only in the following:

(a) Securities in the primary and secondary markets including shares, debentures and warrants of companies, unlisted, listed or to be listed on a recognized stock exchange in India.

(b) units of schemes floated by domestic mutual funds including Unit Trust of India, whether listed or not listed on a recognized stock exchange.
(c) Dated Government securities.
(d) Derivatives traded on a recognized stock exchange.
(e) Commercial paper.
(f) Security receipts.

The total investments in equity and equity related instruments (including fully convertible debentures, convertible portion of partially convertible debentures and tradable warrants) made by a Foreign Institutional Investor in India, whether on his own account or on account of his sub-accounts, should not be less than seventy percent of the aggregate of all the investments of the Foreign Institutional Investor in India, made on his own account and on account of his sub-accounts. However, this is not applicable to any investment of the foreign institutional investor either on its own account or on behalf of its sub-accounts in debt securities which are unlisted or listed or to be listed on any stock exchange if the prior approval of the SEBI has been obtained for such investments. Further, SEBI while granting approval for the investments may impose conditions as are necessary with respect to the maximum amount which can be invested in the debt securities by the foreign institutional investor on its own account or through its sub-accounts. A foreign corporate or individual is not eligible to invest through the hundred percent debt route.

Even investments made by FIIs in security receipts issued by securitization companies or asset reconstruction companies under the Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002 are not eligible for the investment limits mentioned above. No foreign institutional should invest in security receipts on behalf of its sub-account.
Prohibitions on Investments:

Foreign Institutional Investors are not permitted to invest in equity issued by an Asset Reconstruction Company. They are also not allowed to invest in any company which is engaged or proposes to engage in the following activities:

- Business of chit fund
- Nidhi Company
- Agricultural or plantation activities
- Real estate business or construction of farm houses (real estate business does not include development of townships, construction of residential/commercial premises, roads or bridges).
- Trading in Transferable Development Rights (TDRs).

Channels of Foreign Institutional Investments in India:

Portfolio investments in India include investments in American Depository Receipts (ADRs)/ Global Depository Receipts (GDRs), Foreign Institutional Investments and investments in offshore funds. Before 1992, only Non-Resident Indians (NRIs) and Overseas Corporate Bodies were allowed to undertake portfolio investments in India. Thereafter, the Indian stock markets were opened up for direct participation by FIIs. They were allowed to invest in all the securities traded on the primary and the secondary market including the equity and other securities/instruments of companies listed/to be listed on stock exchanges in India.

Entities which can register as FII’s in India:
Entities who propose to invest their proprietary funds or on behalf of “broad based” funds (fund having more than twenty investors with no single investor holding more than 10 per cent of the shares or units of the fund) or of foreign corporate and individuals and belong to any of categories given below can be registered for Foreign Institutional Investors (FII’s).

- Pension Funds
- Mutual Funds
- Investment Trust
- Insurance or reinsurance companies
- Endowment Funds
- University Funds
- Foundations or Charitable Trusts or Charitable Societies who propose to invest on their own behalf
- Asset Management Companies
- Nominee Companies
- Institutional Portfolio Managers
- Trustees
- Power of Attorney Holders
- Banks
- Foreign Government Agency
- Foreign Central Bank
- International or Multilateral Organization
- or an Agency thereof
Some of the above mentioned types are described below:

**Pension funds:** A pension fund is a pool of assets that form an independent legal entity that are bought with the contributions to a pension plan for the exclusive purpose of financing pension plan benefits. It manages pension and health benefits for employees, retirees, and their families. FII activity in India gathered momentum mainly after the entry of CalPERS (California Public Employees’ Retirement System), a large US-based pension fund in 2004.

**Mutual funds:** A mutual fund is a professionally managed type of collective investment scheme that pools money from many investors and invests it in stocks, bonds, short-term money market instruments, or other such securities. The mutual fund will have a fund manager that trades the pooled money on a regular basis. The net proceeds or losses are then distributed to the investors.

**Investment trust:** An Investment trust is a form of collective investment. Investment trusts are closed-end funds and are constituted as public limited companies. A collective investment scheme is a way of investing money with others to participate in a wider range of investments than feasible for most individual investors, and to share the costs and benefits of doing so.

**Investment banks:** An investment bank is a financial institution that raises capital, trades in securities and manages corporate mergers and acquisitions. Investment banks profit from companies and governments by raising money through issuing and selling securities in capital markets (both equity, debt) and insuring bonds (e.g. selling credit default swaps), as well as providing advice on transactions such as mergers and acquisitions.
**Hedge funds:** A hedge fund is an investment fund open to a limited range of investors that is permitted by regulators to undertake a wider range of investment and trading activities than other investment funds, and that, in general, pays a performance fee to its investment manager. Every hedge fund has its own investment strategy that determines the type of investments and the methods of investment it undertakes. Hedge funds, as a class, invest in a broad range of investments including shares, debt and commodities. Many hedge funds investments in India were facilitated by global investors borrowing at near zero interest rates in Japan and investing the proceeds in High interest markets like India.

**University Fund:** The purpose of investments of these funds is to establish an asset mix for each of the University funds according to the individual fund’s spending obligations, objectives, and liquidity requirements. It consists of the University’s endowed trust funds or other funds of a permanent or long-term nature. In addition, external funds may be invested including funds of affiliated organizations and funds where the University is a beneficiary.

**Endowment fund:** It is a transfer of money or property donated to an institution, usually with the stipulation that it be invested, and the principal remain intact in perpetuity or for a defined time period. This allows for the donation to have an impact over a longer period of time than if it were spent all at once.

**Insurance Funds:** An insurance company’s contract may offer a choice of unit-linked funds to invest in. All types of life assurance and insurers pension plans, both single premium and regular premium policies offer these funds. They facilitate access to a wide range and types of assets for different types of investors.
**Asset Management Company:** An asset management company is an investment management firm that invests the pooled funds of retail investors in securities in line with the stated investment objectives. For a fee, the investment company provides more diversification, liquidity, and professional management consulting service than is normally available to individual investors. The diversification of portfolio is done by investing in such securities which are inversely correlated to each other. They collect money from investors by way of floating various mutual fund schemes.

**Nominee Company:** Company formed by a bank or other fiduciary organization to hold and administer securities or other assets as a custodian (registered owner) on behalf of an actual owner (beneficial owner) under a custodial agreement.

**Charitable Trusts or Charitable Societies:** A trust created for advancement of education, promotion of public health and comfort, relief of poverty, furtherance of religion, or any other purpose regarded as charitable in law. Benevolent and philanthropic purposes are not necessarily charitable unless they are solely and exclusively for the benefit of public or a class or section of it. Charitable trusts (unlike private or non-charitable trust) can have perpetual existence and are not subject to laws against perpetuity. They are wholly or partially exempt from almost all taxes. Foreign Institutional Investors are the primary source of portfolio investment in India. In September 1992, the government of India announced the opening of the country’s stock markets to direct participation by FIIs through guidelines for Foreign Institutional Investment. In November 1995, the SEBI (Foreign Institutional Investors) Regulations, 1995 had been notified, which were largely based on the earlier guideline. The regulations require Foreign Institutional Investors to register
with SEBI and to obtain approval from the Reserve Bank of India under the Foreign Exchange Regulations Act, 1973 to enable them to buy and sell securities, to open foreign currency and rupee bank accounts and to remit and repatriate funds.

One category of institutional investors eligible for registration as Foreign Institutional Investors who propose to invest on their own behalf includes Pension Funds, Mutual Funds, Investment Trusts, Insurance Companies, Endowment Funds, University Funds, Foundations or Charitable Trusts or Charitable Societies. The other category of foreign institutional investors, who propose to invest their proprietary funds or on behalf of "broad based" funds which are registered with SEBI as sub-accounts of the FIIs include Asset Management Companies, Investment Advisors, Nominee Companies, Institutional Portfolio Managers, Trustees and Power of Attorney Holders.

It is important to note that apart from fulfilling some conditions under Regulations 6 of SEBI (Foreign Institutional Investors) Regulations, 1995, such as permission under the provision of the Foreign Exchange Regulation Act, 1973 (presently under Foreign Exchange Management Act, 2000) from the Reserve Bank of India and satisfaction of the "Fit and Proper" guidelines issued by SEBI, SEBI would also consider whether the grant of registration is in the interest of the development of the securities market (The Securities Exchange Board of India, Annual Report: 1999-2000).

Foreign Institutional Investors may invest in Indian through two routes: Equity Investment route and 100% Debt route. Under the equity investment route 100% investment could be in the equity related instruments or up to 30% could be invested...
in debt instruments i.e. 30 (Debt Instrument). Under the 100% Debt route, 100% investments have to be made in debt securities only.

In the case of equity route, the Foreign Institutional Investors can invest in the securities in the primary and secondary market, units floated by the Unit Trust of India and other domestic mutual funds and warrants. In the case of debt route, the Foreign Institutional Investors can invest in debentures, bonds, dated government securities, treasury bills and other debt market instruments.

A Foreign Institutional Investors (investing on own behalf) or a sub account can hold up to 10% of paid-up Equity Capital of any Company. The total investments by Foreign Institutional Investors and Sub accounts in any Indian Company cannot exceed 40% of its total paid-up Capital. However, this is subject to

(a) Approval by the board of directors of the company to the enhanced limit up to 40%

(b) A Special resolution passed by the general body of the company approving the enhanced limit up to 40%

The 40% limit does not include investments made by the Foreign Institutional Investors outside the Portfolio Investment route, i.e. through the direct investment approval process. Investment made offshore through purchases of Global Depository Receipts and convertibles are also excluded.

The overall investments limit is monitored by Reserve Bank of India. When the overall Foreign Institutional Investors investment level reaches 38% in a company, Reserve Bank of India gives a caution notice. Subsequently, all purchases have to be
done by prior approval of Reserve Bank of India. However, for Public Sector Banks (except HDFC Bank), the investment limit is 20% and the trigger point is 18%.

Foreign Institutional Investors can make 100% investments in debt securities subject to specific approval from SEBI as a separate category of Foreign Institutional Investors or sub-accounts. Foreign Institutional Investors investments in debt through the 100% debt route to subject to an overall cap under the category of external commercial borrowings. SEBI allocates individual ceilings to Foreign Institutional or sub-accounts within this overall limit on the basis of their track record or experience in debt markets. Foreign Institutional Investors investing through the 100% debt route may either invest proprietary funds or on behalf of broad based funds. There is no limit on investments in the debt securities of any particular issuer. Foreign Institutional Investors are permitted to invest in derivative contracts, which are traded on a recognized stock exchange.

Foreign Institutional Investors have to pay tax at the rate of 10% on long-term capital gains (capital gain on the sale of securities held for a period more than one year is termed as long-term capital gain), at 30% on short-term capital gains (capital gains on the sale of securities held for a period of less than one year is termed as short-term capital gain) and at the rate of 20% on interest income.

The amount invested by Foreign Institutional Investors is fully convertible. For this purpose Foreign Institutional Investors are enquired to seek permission from the Reserve Bank of India under the Foreign Exchange Regulations Act, 1973. This is procured by SEBI.
The stock lending scheme was introduced by SEBI in 1996. The Foreign Institutional Investors, which are active participants in the Indian securities, have been allowed to lend stocks through an approved intermediary. However, presently the Foreign Institutional Investors are not permitted to borrow securities, which could result into covered short sales, by the Foreign Institutional Investors.

While announcing the policy measures relating to the Government securities market in the credit policy announcement an April 29, 1998. The RBI allowed FIIls to invest in treasury bills within the overall approved debt ceiling. A previous amendment in 1997 had permitted FIIls to invest in proprietary funds and also to invest in dated government securities. The Finance Minister in his budget speech for 1998-99 announced that Foreign Institutional Investors investing through the 100 percent debt route would be permitted to invest in unlisted securities. Amendments to this effect have been approved and notified by the SEBI. The SEBI (Foreign Institutional Investors) Regulations, 1995 require FIIls to enter into secondary market transactions only through stockbrokers registered with SEBI. To facilitate the participation of FIIls in open offers, the FIIls have now been permitted to tender their securities directly in response to an open offer made in terms of SEBI (Substantial Acquisition of Shares and Takeover) Regulations, 1997.

As FIIls are potential participants in the derivatives markets; it was felt that the presence of FIIls and domestic institutions would be crucial to the success of the market. It was; therefore, decided to permit FIIls to buy and sell derivative contracts traded on a stock exchange.
In terms of regulations 12 and 13 of the SEBI (Foreign Institutional Investors) Regulations, 1995, FIIs may invest on behalf of sub-accounts which are registered with SEBI. When considering an application for registration of sub-accounts, the Regulations required submission of detailed information for registration. Under this procedure, considerable time was sometimes taken in determining whether the applicant was “broad based” as required by the Regulations. To simplify the registration process for sub-accounts it has been decided that the determination of fulfillment of broad base criteria be done by the Foreign Institutional Investors itself and a declaration to this effect be submitted to SEBI. The Regulations have been amended to incorporate a simplified format for registration of sub-accounts under which registration is now granted within three days of receipt of application.

With a view to expand the Foreign Institutional Investors, it has been decided by the government to permit the following categories of investors and arrangements to invest through the FII Portfolio Investment route (The Ministry of Finance, The Government of India, Annual Report, 1999-00):

(a) to permit foreign corporates and high net worth individuals to invest through SEBI registered FIIs, such investment will be subject to a sub-limit of 5% within the aggregate limit for FII portfolio investments of 40% in a single company; and

(b) to permit SEBI registered domestic fund managers to manage foreign funds for investments in the Indian capital market through the portfolio investment route provided the funds are channeled through internationally recognized
financial institutions and subject to the reporting requirements as applicable to FIIs.

Salient Features of FIIs:

1. FIIs including pension funds, mutual funds, investment trust, asset management companies, Nominee Company, bank, incorporated/institutional portfolio manager or their power of attorney holder (providing discretionary and non discretionary portfolio management services) would be welcomed to make investments under the new guidelines. Investment in all securities traded on the primary and secondary markets including the equity and other securities/instruments of companies which are listed/to be listed on the stock exchanges in India including the OTC exchange of India is permitted. The instrument includes shares, debentures, warrants, and scheme floated by domestic mutual funds. Government may even add further categories of securities from time to time.

2. FIIs would be required to obtain an initial registration with SEBI to enter the market. Nominee companies, affiliated and subsidiary companies of an FII will be treated as separate FIIs for registration and may seek separate registration with SEBI.

3. Since there are foreign exchange controls in force, FIIs shall also seek various permissions under FERA from the RBI, both SEBI and RBI registration will be under a single window approach.
4. FIIs seeking initial registration with SEBI shall be required to hold a registration from the securities commission or such other regulatory organization for the stock market in their country of domicile/incorporation.

5. SEBI’s initial registration would be valid for 5 years. RBI’s general permission under FERA to the FII will also hold good for five years, both will be renewable for similar five periods later on.

6. Under the FERA permission, FIIs will be able to buy, sell and realize capital gains on investments made through the initial corpus remitted to India, subscribe/renounce rights offering of shares invest on all recognized stock exchanges through a designated bank branch and appoint a domestic custodian for custody of the investment.

7. The general permission from the RBI will enable the FIIs to:
   i. Open foreign currency account(s) in a designated bank (there can be more than one account in the same bank branch, in different currencies, if so required by the FII for its operational purpose).
   ii. Open a special non-resident rupee account to which all receipts from the capital inflows, sale proceeds of shares dividends and interest could be credited.
   iii. Transfer sums from the foreign currency accounts to the rupee accounts and vice-versa, at the market rates of exchange.
   iv. Make investment in securities in India out of the balances in the rupee accounts.
v. Transfer repatriable (after tax) proceeds from the rupee account to the foreign currency accounts.

vi. Repatriate the capital, capital gains, dividends, income received by the way of interest etc; and any compensation received towards sale/renouncement of rights offering of shares subject to the designated branch of a bank/custodian being authorized to deduct withholding tax on capital gains and arranging to pay such tax and remitting the net proceeds at market rates of exchange.

vii. Register FII’s holding without any further clearance under FERA.

8. There would be no restrictions on the volume of investment-minimum or maximum for the purpose of entry FIIs in the primary/secondary markets and also on the lock in period described for the purpose of such investments made by FIIs, however, portfolio investment in primary and secondary markets will be subjected to ceiling of 24% of issued share capital for the total holding of all registered FIIs in any one company. Conversions, out of the fully and partly convertible debentures issued by the company will also be taken into account for the purpose. The holding of a single FII in any company would be subject to a ceiling of 5% of total issued share capital for which purpose, holding of an FII group will be counted as holdings of a single FII.
9. The maximum holding of 24% for all non-residential portfolio investments including those of the registered. FII's will also include NRI corporate and non-corporate investments, but will not include; direct foreign investment (which are permitted up to 51% or 74% or even full in all priority sector) and investments by FII's through the following alternatives offshore single/ regional funds, global depository receipts and euro convertibles.

10. Disinvestment will be allowed only through stock exchanges in India including OTCEI. SEBI may permit sales other than through stock exchanges, provided the sale prices are not significantly different from the stock market quotations, where available.

11. All secondary market operations would be only through the recognized intermediaries on the Indian stock exchange including OTCEI. FII's would not be expected to take delivery of purchased and give delivery of sold securities.

12. FII's can appoint an custodian an agency approved by SEBI as a custodian of securities and for confirmation of transaction in securities, settlement of purchase and sale and for information reporting such a custodian shall establish separate accounts for detailing on a daily basis the investment capital utilization and securities held by each FII for which it is acting as custodian will report to the RBI and SEBI semi-annually, as part of their disclosure and reporting guidelines.

13. RBI may at any time request by an order, a registered FII to submit information regarding records of the utilization of the inward remittances of investment capital and the statement of its securities transactions. RBI and / or
SEBI may also any time conduct a direct inspection of the records and accounting books of a registered FII.

14. FIIs investing under this scheme will benefit from a concessional tax regime of a flat tax rate of 20% on dividend and interest income and a tax rate of 10% on long-term (one or more year) capital gains.

**Portfolio Investment: Theoretical Issues**

With the ongoing globalization the role of institutional investors in foreign capital flows has increased to a great extent. They are being regarded as kingpin of financial globalization. But what are the possible gains from foreign institutional investments. The developing countries like India generally have a chronic shortage of capital. The entry of FIIs is expected to bring that much needed capital. However, as most of purchases by FIIs are on secondary market, their direct contribution to investment may not be very significant. Yet, FIIs contribute indirectly in a number of ways towards increasing capital formation in the host country. Increased participation of foreign investors increases the potentially available capital for investment and thus lowers the cost of capital. Further, purchases of FIIs give an upward thrust to domestic stock prices and thus increase the price-earnings ratio of firm. Both these factors are expected to increases overall level of investment in an economy. Thus, FIIs can prove to be an important boost for capital formation.

Portfolio investment is also expected to improve the functioning of domestic stock exchanges. The host country seeking foreign portfolio investment has to improve its trading and delivery system. Also, consistent and business friendly policies have to be followed in order to retain the confidence of foreign investors. Further, portfolio
investors are known to have highly competent financial analyst. They have access to most advanced technology, best possible information and vast and global experience in investment business. Due to these qualities the entry of FIIs can substantially increase the allocative efficiency of domestic stock market.

However, increased activities of FIIs in developing countries can also have negative impacts. Since the 1996 Mexican crises and widespread Asian crises, many economists have questioned the wisdom of policy-makers in developing world in indiscriminately inviting portfolio flows. Institutional investments are highly volatile and even in case of small economic problem investors can destabilize the economy by making large and concerted withdrawals. Many possible reasons have been mentioned in literature for explaining the volatility of portfolio investment. A straight forward reasoning follows from the fact that institutional investors actually act as agents of principle fund owners. The later generally observe the performance of agent investors at a short notice, often on the basis of quarterly reports. Because of this FIIs face very short-term performance targets. So they do not afford to stick to a lose making position even for a short period and withdraw at the first sign of trouble. Further, as the fund owners can shift between agent investors in very short period, the later follow the performance and activities of each other very closely. When one agent withdraws from an economy realizing the initial sign of trouble, the others also follow the suit. Thus, a small economic problem can be converted into an economic disaster due to the herding behavior of FIIs.

Another problem with portfolio investment is that it influences the domestic exchange rate and can cause its artificial appreciation. The inflow of foreign capital
raises the demand for non-tradable goods, which results in appreciation of the real exchange rate. With a floating exchange rate regime and no central bank invention, the appreciation will take place through nominal rate (Kohli, Renu 2001).

The net impact of foreign institutional investment in a country, therefore depends upon the policy response of concerned authority regarding the problems posed by such investment.

**Chronology of important regulations related to FIIs:**

**Panel A: 1995 to 1998:**

**November-95:** SEBI empowered by the Securities and Exchange Board of India Act, 1992 institutionalized the FII regulations, known as the Securities and Exchange Board of India (Foreign Institutional Investors) Regulations, November 14, 1995, allowing Pension Funds, Mutual Funds or Investment Trusts, incorporated outside India; any Asset Management Company or Nominee Company, Bank or Institutional Portfolio Manager, established or incorporated outside India and proposing to make investments in India on behalf of broad based funds any Trustee or Power of Attorney holder, Incorporated or established outside India, and proposing to make Investments in India on behalf of broad based funds to apply for FII Status to carry out trading in equities and debentures listed on the Indian stock exchanges.

**October-96:** University fund, endowments, foundations or charitable trusts or Charitable societies were considered eligible for being registered as FIIs; FIIs were allowed to invest in unlisted companies; Equity share investment on
own account and on behalf of subaccounts Increases to 10 from 5 per cent, of total capital issue of Company. Custodians asked to become members of the clearing houses / Clearing corporations of the stock exchange(s) and participate in the Clearing and settlement process through the clearing house/clearing Corporation for all securities.

**February-97:** Proprietary funds were included as eligible FIIIs (for FII and subaccount)

**November-97:** SEBI allowed institutional investors, FIIIs, stock brokers, stock Exchanges etc. to make use of the facility of warehousing of trades.

**December-97:** FIIIs mandated to meet certain criteria of proving to be a fit and proper person. Mandatory for FIIIs having securities of Rs.10 crores or more, as on the latest balance sheet date, to settle their transactions only through dematerialized securities from January 15, 1998.

**April-98:** The gilts market was opened up to FII investment. Investments in Treasury bills and dated Government Securities were allowed within the overall approved debt ceilings. Stock lending permitted through an approved intermediary in Accordance with stock lending scheme

**June-98:** FIIIs allowed to invest in unlisted companies through the 100 per cent debt route FIIIs asked to tender their securities directly in response to an open offer made in terms of the SEBI (Substantial Acquisition of Shares and Takeovers) Regulations, 1997; FIIIs allowed to buy and sell derivative (index futures) contracts traded on a stock exchange; FIIIs permitted to trade in derivatives without requiring to take or give delivery; Transactions among FIIIs with
respect to Indian stocks would no longer require the post facto confirmation from RBI; Process of approval of sub-accounts of registered FIIs simplified.

Trigger point limit for investments in Indian companies by FIIs/ NRIs/ OCBs under the portfolio scheme was raised by 2 percentile points; ADs were to be permitted to provide forward cover to FIIs in respect of their fresh investments in India, in equity, effective June 12, 1998. ADs were to be allowed to extend forward cover facility to FIIs to cover the appreciation in the market value of their existing investments in India. The amount eligible for cover would be the (i) difference between the market value of their investments as at the close of business on June 11, 1998 (converted at the RBI reference rate of Rs.42.38 per US Dollar) and the market value of investments at the time of providing the cover converted at the current rate; or (ii) fresh inflows (including reinvestments of cash balances lying in the accounts of the FIIs at the close of business on June 11, 1998) since June 11,1998, whichever is higher. ADs were given the option of extending the cover fund-wise or FII-wise according to their operational feasibility. The same facility was extended to NRIs/ OCBs for their portfolio investments, effective June 16, 1998.

Panel B: 1999 onwards

16-April 1999: In respect of investments in the secondary market, FIIs were allowed to participate in open offers in accordance with take-over codes; in case of an open offer by a company to buy-back its securities, the FIIs may sell the securities held by it to such company in accordance with the SEBI (Buy-Back of securities) Regulations, 1998.
24-April 1999: Cut-off date for providing forward exchange cover to FIIs in respect of their equity investment was changed from June 11, 1998 to March 31, 1999 and Authorized Dealers (ADs) were permitted to provide forward exchange cover to FIIs to the extent of 15 per cent of their outstanding equity investment as at the close of business on

31-March 1999: as well as for the entire amount of any additional investment made after March 31, 1999. Existing forward contracts booked in accordance with earlier instructions are allowed to continue even if the amount thereof exceeded 15 per cent of the value of investment as on March 31, 1999. The RBI would also consider requests from FIIs for additional limits on case by case basis after the eligible limits have been fully utilized.

29-February 2000: A domestic portfolio manager or domestic asset management company were made eligible to be registered as a foreign institutional investor to manage the funds of sub-accounts, provided the applicant is an approved asset management company or a registered portfolio manager and that the approval or registration is valid and no disciplinary proceeding is pending before the Board against such applicant. In case of foreign corporate or individuals, investing in equity, each of such sub-account (substituted for all sub accounts together) shall not invest more than 5% of the total issued capital, within the aggregate limit of 24%, of the company in which such investment is made. Non-resident Indians (NRIs) and overseas corporate bodies (OCBs) registered with RBI shall not be eligible to invest as sub-account or as foreign institutional investor.
28-March 2000: Any person aggrieved by an order of the Board made, on and after the commencement of the Securities Laws (Second Amendment) Act, 1999, (i.e., after 16th December 1999), under these regulations may prefer an appeal to a Securities Appellate Tribunal having jurisdiction in the matter. The SAT replaces the Central Government for this purpose.

24-April 2000: Indian companies (other than banking companies) including those which have already enhanced the aggregate ceiling from the normal level of 24% to 30% were permitted to enhance the aggregate ceiling on FII investment up to 40% of the issued and paid-up capital.

28-November 2000: SEBI simplified the procedures for FIIs permitting them to execute clients’ orders immediately and do the registration later within a day or two. The move will help the FIIs to proceed with execution of requests of clients, who are mostly from outside the country without waiting for SEBI clearance for each transaction.

28-February 2001: Increased the ceiling for investment by FIIs from 40% to 49% with the approval of the shareholders through a special resolution in the General Body Meeting. FIIs were initially allowed to invest in a company under the portfolio investment route up to 24% of the paid up capital of the company. This was previously allowed to be increased to 40% with the approval of the General Body of the shareholders by a special resolution.

20-September 2001: In consultation with the Government, RBI permitted Indian companies to increase the FII investment limit up to the sectoral cap/ statutory ceiling, as applicable.
27-February 2002: FII s permitted to trade in all exchange traded derivative contracts; FII portfolio investments will not be subject to the sectoral limits applicable for FDI except in specified sectors.

10-December 2002: Every applicant eligible for grant of a certificate under Regulation 7 shall pay a registration fee of US$ 5,000 [reduced from “US $ 10,000].

28-August 2003: Regulation 7A introduced mandating that a foreign institutional investor holding a certificate shall, at all time, and abide by the Code of Conduct as specified in Third Schedule.

17-December 2003: Decided to permit SEBI registered FII s/ subaccounts of FII s to buy/ sell equity shares/ debentures of Indian companies (excluding companies engaged in the print media sector), units of domestic mutual funds, dated Government Securities and Treasury Bills through stock exchanges in India at the ruling market price, invest / trade in exchange traded derivative contracts, and also to buy/ sell shares and debentures etc. of listed/ unlisted companies otherwise than on stock exchange at a price approved by SEBI/ Reserve Bank as per terms and conditions prescribed in the Annexure.

For the purpose of FII investment, Government Securities would include dated securities of both Government of India and State Governments of all maturities and Treasury Bills of Government of India. Investment in Government dated securities and Treasury Bills by FII s may be made either in the primary market (at the auction/ floatation) or in the secondary market.
**Expected Gains of FII Investment**

The advantages of having FII Investment can be broadly classified under the following categories:

**(A). Enhanced flows of equity capital:**

FIIs are well known for a greater appetite for equity than debt in their asset structure. For examples, pension funds in the United Kingdom and United States had 68 percent and 64 percent, respectively of their portfolios in equity in 1998. Thus, opening up the economy to FIIs is in line with the accepted preference for non-debt creating foreign inflows over foreign debt. Furthermore, because of this preference for equities over bonds, FIIs can help in compressing the yield-differential between equity and bonds and improve corporate capital structures. Further, given the existing saving investment gap of around 1.6 percent, FII inflows can also contribute in bridging the investment gap. So that sustained high GDP growth rate of around 8 percent targeted under the 10th five year plan can be materialize. Equity return has a significant and positive impact on the FII investment (Agarwal, 1997; Chakrabarti, 2001; Trivedi and Nair, 2003). But given the huge volume of investments, foreign investment could play a role of market makers and book their profits and enhanced equity capital in the host country.

**(B). Improving capital markets:**

FIIs as professional bodies of asset managers and financial analysts enhance competition and efficiency of financial markets. Equity market development aids economic development. By increasing the availability of riskier long term capital for projects, and increasing firms’ incentives to supply more information about
themselves, the FIIIs can help in the process of economic development. The increasing role of institutional investors has brought both quantitative and qualitative developments in the stock markets viz., expansion of securities business, increased depth and breadth of the market, and above all their dominant investment philosophy of emphasizing the fundamentals has rendered efficient pricing of the stocks (Khanna, 2002). Rangrajan (2000) suggested that foreign portfolio investments would help the stock markets directly through widening investors’ base and indirectly by compelling local authorities to improve the trading system. Chakrabarti (2006), however, argues that the FII flows should be viewed not in isolation but as a part of an integrated policy package for all capital receipts keeping in mind their role in the overall macroeconomic structure.

**(C). Improved corporate governance:**

Good corporate governance is essential to overcome the principal-agent problem between shareholders and management. Information asymmetries and incomplete contracts between shareholders and management are at the root of the agency costs. Dividend payment, for example, is discretionary. Bad corporate governance makes equity finance a costly option. With boards often captured by managers or passive, ensuring the rights of shareholders is a problem that needs to be addressed efficiently in any economy. Incentives for shareholders to monitor firms and enforce their legal rights are limited and individuals with small shareholdings often do not address the issue since others can free-ride on their endeavor. What is needed is large shareholders with leverage to complement their legal rights and overcome the free-rider problem, but shareholding beyond say 5 per cent can also lead to
exploitation of minority shareholders. FII{s constitute professional bodies of asset managers and financial analysts, who, by contributing to better understanding of firms’ operations, improve corporate governance. Among the four models of corporate control – takeover or market control via equity, leveraged control or market control via debt, direct control via equity, and direct control via debt or relationship banking – the third model, which is known as corporate governance movement, has institutional investors at its core. In this third model, board representation is supplemented by direct contacts by institutional investors. Institutions are known for challenging excessive executive compensation, and remove underperforming managers. There is some evidence that institutionalization increases dividend payouts, and enhances productivity growth. Douma, Pallathiatta and Kabir (2006) investigated the impact of foreign institutional investment on the performance of emerging market firms and found that there is positive effect of foreign ownership on firm performance. They also found impact of foreign investment on the business group affiliation of firms. Aggarwal, Klapper and Wysocki (2005) observed that foreign investors preferred the companies with better corporate governance. Yin-Hua and Woidtke (2005) found that when company boards are dominated by members who are affiliated to the controlling family, investor protection will be relatively weak and it is difficult to determine the degree of separation of management from ownership. They also observed that firm value is negatively related to board affiliation in family controlled firms. Li (2005) observed that in case of poor corporate governance the foreign investors choose foreign direct investment (FDI) rather than indirect portfolio investment. It is generally believed
that FDI could be better protected by private means. Increase in the foreign shareholding increases the firm performance. And also find that there is alignment effect between the promoter shareholding and the asset turnover ratio (Sarkar and Sarkar, 2002) (Bhattacharya and Rao,)

(D). Managing uncertainty and controlling risks:
Institutional investors promote financial innovation and development of hedging instruments. Institutions, for example, because of their interest in hedging risks, are known to have contributed to the development of zero-coupon bonds and index futures. FIIs, as professional bodies of asset managers and financial analysts, not only enhance competition in financial markets, but also improve the alignment of asset prices to fundamentals. Institutions in general and FIIs in particular are known to have good information and low transaction costs. By aligning asset prices closer to fundamentals, they stabilize markets. Fundamentals are known to be sluggish in their movements. Thus, if prices are aligned to fundamentals, they should be as stable as the fundamentals themselves. Furthermore, a variety of FIIs with a variety of risk-return preferences also help in dampening volatility.

(E). Reduced cost of equity capital:
FII inflows augment the sources of funds in the Indian capital markets. In a common sense way, the impact of FIIs upon the cost of equity capital may be visualized by asking what stock prices would be if there were no FIIs operating in India. FII investment reduces the required rate of return for equity, enhances stock prices, and foster investments by Indian firms in the country. From the perspective of international investors, the rapidly growing emerging markets offer potentially
higher rates of return and help in diversifying portfolio risk. This has been empirically confirmed by Divecha, et al. (1992) and Harvey (1995). It is argued that FPI flows increase the stock prices in the recipients markets, which in turn increases the Price-Earning (P/E) ratio of the concerned firms. Increase in P/E ratio tends to reduce the cost of capital and boosts the stock markets. This phenomenon has been witnessed in the case of Asian and Latin American countries (Calvo, 1996). The cost of equity capital is also cut down due to the sharing of risk by the foreign investors. This reduction in the cost of equity could result in increased physical investment (Henry, 2000). Some investment projects with a negative Net Present Value (NPV) before the entry of foreign investors can turn into projects with positive NPV after their entry. As a result, there is boost to primary issues in such markets.

(F). Imparting stability to India’s Balance of Payments:

For promoting growth in a developing country such as India, there is need to augment domestic investments, over and beyond domestic saving, through capital flows. The excess of domestic investment over domestic savings result in a current account deficit and this deficit is financed by capital flows in the balance of payments. Prior to 1991, debt flows and official development assistance dominated these capital flows. This mechanism of funding and current account deficit is widely believed to have played a role in the emergence of balance of payments difficulties in 1981 and 1991. Portfolio flows in the equity markets, and FDI as opposed to debt-creating flows, are important as safer and more sustainable mechanisms for funding the current account deficit. Bandopadhyay (2005) has found that the portfolio capital helps many developing economies in mitigating their balance of payments deficit as
well as maintaining liquidity in the financial markets. It is also observed that both return in the source country stock market and the inflation rate do not find any impact on the FII. Agarwal (1997) has, however, found that the world stock market capitalization has a favorable impact on the FPI in India.

(G). Knowledge Flows:
The activities of international institutional investors help strengthen Indian finance. FIIs advocate modern ideas in market design, promote innovation development of sophisticated products such as financial derivatives, enhance competition in financial intermediation, and lead to spillovers of human capital by exposing Indian participants to modern financial techniques, and international best practices and systems.

(H). Improvements to market efficiency:
A significant presence of FIIs in India can improve market efficiency through two channels. First, when adverse macro economic news, such as bad monsoons, unsettles many domestic investors, it may be easier for a globally diversified portfolio manager to be more dispassionate about India’s prospects and engage in stabilizing trades. Second, at a level of individual stocks and industries, FIIs may act as a channel through which knowledge and ideas about valuation of a firm or an industry can more rapidly propagate into India. For example, foreign investors were rapidly able to assess the potential of the firms like Infosys, which are primarily expert oriented, applying valuation principles, and the prevailed outside India for
software services companies. In the Indian context, the FIIIs are said to have been instrumental in promoting market efficiency and transparency (Chopra, 1995). The argument, in favor of this conclusion, is that the advent of FIIIs has benefited all investors by offering them a wider range of instruments with varying degrees of risk, return and liquidity. Hence, the policy measures have been targeted towards promoting more FII investment.

**Disadvantages of FII Investment**

There are also some disadvantages of FII Investment which are broadly classified under the following categories:

**(A). Volatility and capital outflows:**

There is also increasing possibility of abrupt and sudden outflows of capital if the inflows are of a short-term nature as in the case of portfolio inflows of FIIIs. The recent experience of reversal of private capital flows observed in Global crisis of 2008, Asian crisis in 1997 and in Mexico during the later part of 1994 due to sudden change in FIIIs' investment sentiment provides a vivid illustration of such risks. Usually, FIIIs take into account some specific risks in emerging markets such as (i) political instability and economic mismanagement, (ii) liquidity risk and (iii) currency movement. Currency movement can have a dramatic impact on equity returns of FIIIs, a depreciation having an adverse effect. The withdrawal of FIIIs from ASEAN countries led to large inflow of funds to FIIIs to India for which equity market in India is buoyant at present. Thus, short-term flows including portfolio flows of FIIIs to developing countries in particular are inherently unstable and increases volatility of the emerging equity markets. They are speculative and
respond adversely to any instability either in the real economy or in financial variables. Investment in emerging markets by FIIs can at times be driven more by a perceived lack of opportunities in industrial countries than by sound fundamentals in developing countries including India. Emerging stock markets of India and other developing countries have a low, even negative correlation with the stock markets in industrial nations. So, when the latter goes down, FIIs invest more in the former as a means to reduce overall portfolio risk. On the other hand, if there is boom in industrial countries, there may be reverse flow of funds of FIIs from India and other developing countries. Of course, there is pull for international private portfolio investment of FIIs due to the impact of wide-ranging macro-economic and structural reforms including liberalization or elimination of capital restrictions, improved flow of financial information, strengthening investors' protection and the removal of barriers on FIIs' participation in equity markets in India and other emerging markets. However, to the extent, FIIs view emerging markets as a single-asset class, shocks in one country or region can also be transmitted to other emerging markets producing volatile collapsing share price behavior (Aitken 1996; Richards 1996). FII inflows are popularly described as “hot money”, because of the herding behavior and potential for large capital outflows. Herding behavior, with all the FIIs trying to either only buy or only sell at the same time, particularly at times of market stress, can be rational (Bikhchandani, S and S. Sharma, 2000). With performance-related fees for fund managers, and performance judged on the basis of how other funds are doing, there is great incentive to suffer the consequences of being wrong when everyone is wrong, rather than taking the risk of being wrong when some others are right. The
incentive structure highlights the danger of a contrarian bet going wrong and makes it much more severe than performing badly along with most others in the market. It not only leads to reliance on the same information as others but also reduces the planning horizon to a relatively short one. Another source of concern are hedge funds, who, unlike pension funds, life insurance companies and mutual funds, engage in short-term trading, take short positions and borrow more aggressively, and numbered about 6,000 with $500 billion of assets under control in 1998.

(B). **Price rigging:**

Bear hammering by FIIs has been alleged in case of almost all companies in India tapping the GDR market. The cases of SBI and VSNL are most illuminating to show how the FIIs manipulate domestic market of a company before its GDR issues. The manipulation of FIIs, working in collusion operates in the following way. First, they sell en masse and then when the price has been pulled down enough, pick up some shares cheaply in the GDR market. Though FIIs have the freedom of entry and exit, they alone have the access to both the domestic as well as the GDR market but the GDR market is not open to domestic investors. Hence FIIs gain a lot at the cost of domestic investors due to their manipulation which is possible owing to integration of Indian equity market with global market consequent upon liberalization.

(C). **Herding and positive feedback trading:**

There are concerns that foreign investors are chronically ill-informed about India, and this lack of sound information may generate herding (a larger number of FIIs buying or selling together). These kinds of behavior can exacerbate volatility, and push prices away from fair values. FIIs behavior in India however, so far does not
exhibit these patterns. FIIIs have come to play a dominant role in the India’s stock market like never before. The pace of their inflows into equities is picking up momentum over the years. What would it mean for the Indian stock market? Dornbusch and Park (1995) suggest that foreign investors pursue positive feedback trading strategies that make stocks over react to changes in fundamentals. Bonser, Neal et al. (2002) analyze the foreign trading behavior on the Jakarta stock exchange (Indonesia) between 1995 and 2002. They detect herding and positive feedback trading by foreign investors but find no evidence to indicate that such trading behavior by foreign investors destabilized the market price during the Asian crisis. Griffin et al. (2002) use a theoretical model and empirical analysis to show that global stock return performance is an important factor in understanding equity inflows. Batra, Amit (2003) indicates that foreign investors have a tendency to herd on the Indian equity market even though they all may not do it on the same day. In times of pressure in the stock market on account of financial crisis in the region there is excessive sell side herding even though the extent of herding on the average and on either side of the market during the crisis may be lower than in the immediately preceding period. Generally, contrary to ‘herding’, FIIIs are seen to be involved in very large buying and selling at the same time. Gordon and Gupta (2003) also find evidence against positive feedback trading with FIIIs buying after negative returns and vice-versa.

(D). BOP vulnerability:
There are concerns that in an extreme event, there can be a massive flight of foreign capital out of India, triggering difficulties in the balance of payments front. India’s experience with FII’s so far, however, suggests that across episodes like the Pokhran blasts, or the 2001 stock market scandal, no capital flight has taken place. A billion or more of US dollars of portfolio capital has never left India within the period of one month. When juxtaposed with India’s enormous current account and capital flows, this suggests that there is little evidence of vulnerability so far.

(E). Possibility of taking over companies or backdoor control:

Besides price rigging, FII’s are trying to control indigenous companies through the GDR route where they are also active. GDRs acquire the voting rights once an ordinary share gets converted into equity within a specified limit. So, the GDR route which is considered as FDI plus portfolio investment is a roundabout way adopted by FII’s to gain control of indigenous companies. While FII’s are normally seen as pure portfolio investors can occasionally behave like FDI investors, and seek control of companies that they have a substantial shareholding in. Such outcome, however, may not be inconsistent with India’s quest for greater FDI. Furthermore, SEBI’s takeover code is in place and has functional fairly well, ensuring that all investors benefit equally in the event of a takeover.
(F). **Money laundering**:

The movement of hot money of FIIs due to integration of emerging markets of India and other countries with global market have helped the hawala traders and criminal elements an easy means to launder international money from illegal activities which in consequence have also an impact on equity market. Sometimes FIIs act as an agent for money laundering (Quirk 1996; Tanzi 1996). It is also argued that the FII indulge in price rigging by collusive operation. Another ill effect of opening up of the capital market to FIIs has been the possibility of FIIs trying to gain control of indigenous companies. Finally, it is alleged that FIIs might indulge in money laundering transactions (Aitken, 1996; Richards, 1996). Hence, some authors have argued that FIIs have no significant benefits for the economy at large (Pal, 1998; Samal, 1997).

(G). **Management control**

FIIs act as agents on behalf of their principals – as financial investors maximizing returns. There are domestic laws that effectively prohibit institutional investors from taking management control. For example, US law prevents mutual funds from owning more than 5 per cent of a company’s stock. According to the International Monetary Fund’s Balance of Payments Manual 5, FDI is that category of international investment that reflects the objective of obtaining a lasting interest by a resident entity in one economy in an enterprise resident in another economy. The lasting interest implies the existence of a long-term relationship between the direct investor and the enterprise and a significant degree of influence by the investor in the management of the enterprise. According to EU law, foreign investment is labeled direct investment when the investor buys more than 10 per cent of the
investment target, and portfolio investment when the acquired stake is less than 10 per cent.

Institutional investors on the other hand are specialized financial intermediaries managing savings collectively on behalf of investors, especially small investors, towards specific objectives in terms of risk, returns, and maturity of claims.

All take-overs are governed by SEBI (Substantial Acquisition of Shares and Takeovers) Regulations, 1997, and sub-accounts of FIIs are deemed to be “persons acting in concert” with other persons in the same category unless the contrary is established. In addition, reporting requirement has been imposed on FIIs and currently Participatory Notes cannot be issued to un-regulated entities abroad.

Some of these issues have been relevant right from 1992, when FII investments were allowed in. The issues, which continue to be relevant even today, are: (i) benchmarking with the best practices in other developing countries that compete with India for similar investments; (ii) if management control is what is to be protected, is there a reason to put a restriction on the maximum amount of shares that can be held by a foreign investor rather than the maximum that can be held by all foreigners put together; and (iii) whether the limit of 24 per cent on FII investment will be over and above the 51 per cent limit on FDI. There are some other issues such as whether the existing ceiling on the ratio between equities and debentures in an FII portfolio of 70:30 should continue or not, but this is beyond the terms of reference of the Committee. It may be noted that all emerging peer markets have some restrictions either in terms of quantitative limits across the board or in specified sectors, such as, telecom, media, banks, finance companies, retail trading
medicine, and exploration of natural resources. Against this background, further across the board relaxation by India in all sectors except a few very specific sectors to be excluded, may considerably enhance the attractiveness of India as a destination for foreign portfolio flows. It is felt that with adequate institutional safeguards now in place the special procedure mechanism for raising FII investments beyond 24 per cent may be dispensed with. The restrictions on foreign ownership of companies in emerging markets have been summarized in Annex-III.

**Differences between FII & FDI (FII versus FDI)**

FDI and FIIs are two important sources of foreign financial flows into a country.

FDI (Foreign Direct Investment) the acquisition abroad of physical assets such as plant and equipment, with operating control residing in the parent corporation. It is an investment made to acquire a lasting management interest (usually 10 percent of voting stock) in an enterprise operating in a country other than that of the investor, the investor’s purpose being an effective voice in the management of the enterprise. It includes equity capital, reinvestment of earnings, other long term capital, and short-term capital. Usually countries regulate such investments through their periodic policies. In India such regulation is usually done by the Finance Ministry at the Centre through the Foreign Investment Promotion Board).

**Types of Investments**

FDI typically brings along with the financial investment, access to modern technologies and export market. The impact of the FDI in India is far more than that of FII largely because the former would generally involve setting up of production base - factories, power plant, telecom networks, etc. that enables direct generation of
employment. There is also multiplier effect on the back of the FDI because of further domestic investment in related downstream and upstream projects and a host of other services. Korean Steel maker Posco’s US$ 8 billion steel plant in Orissa would be the largest FDI in India once it commences. Maruti Suzuki has been an exemplary case in the India's experience. However, the issue is that it puts an impact on local entrepreneur as he may not be able to always successfully compete in the face of superior technology and financial power of the foreign investor. Therefore, it is often regulated that Foreign Direct Investments should ensure minimum level of local content, have export commitment from the investor and ensure foreign technology transfer to India.

FII investments into a country are usually not associated with the direct benefits in terms of creating real investments. However, they provide large amounts of capital through the markets. The indirect benefits of the market include alignment of local practices to international standards in trading, risk management, new instruments and equities research. These enable markets to become more deep, liquid, feeding in more information into prices resulting in a better allocation of capital to globally competitive sectors of the economy. Since, these portfolio flows can technically reverse at any time, the need for adequate and appropriate economic regulations are imperative.

**Government's Preference**

FDI is preferred over FII investments since it is considered to be the most beneficial form of foreign investment for the economy as a whole. Direct investment targets a specific enterprise, with the aim of enhancing capacity and productivity or changing
its management control. Direct investment to create or augment capacity ensures that the capital inflow translates into additional production. In the case of FII investment that flows into the secondary market, the effect is to increase capital availability in general, rather than availability of capital to a particular enterprise. Translating an FII inflow into additional production depends on production decisions by someone other than the foreign investor — some local investor has to draw upon the additional capital made available via FII inflows to augment production. In the case of FDI that flows in for acquiring an existing asset, no addition to production capacity takes place as a direct result of the FDI inflow. Just like in the case of FII inflows, in this case too, addition to production capacity does not result from the action of the foreign investor – the domestic seller has to invest the proceeds of the sale in a manner that augments capacity or productivity for the foreign capital inflow to boost domestic production. There is a widespread notion that FII inflows are hot money — that it comes and goes, creating volatility in the stock market and exchange rates. While this might be true of individual funds, cumulatively, FII inflows have only provided net inflows of capital.

**Stability**

FDI tends to be much more stable than FII inflows. Moreover, FDI brings not just capital but also better management and governance practices and, often, technology transfer. The knowhow thus transferred along with FDI is often more crucial than the capital per se. No such benefit accrues in the case of FII inflows, although the search by FIIs for credible investment options has tended to improve accounting and governance practices among listed Indian companies.
The other difference between FII and FDI are follows:

(A). According to the International Monetary Fund’s Balance of payments Manual 5, FDI is that category of international investment that reflects the objective of obtaining a lasting interest by a resident entity in one economy in an enterprise resident in another economy. The lasting interest implies the existence of a long-term relationship between the direct investor and the enterprise and a significant degree of influence by the investor in the management of the enterprise. According to EU law, foreign investment is labeled direct investment, when the investors buys more than 10 percent of the investment target, and portfolio investment when the acquired stake is less than 10 percent. Institutional investors on the other hand are specialized financial intermediaries managing savings collecting on behalf of investors, especially small investors, towards specific objectives in terms of risk, returns and maturity of claims.

(B). While permitting foreign firms/ high net worth individuals in Feb, 2000 to invest through SEBI registered FII/ domestic fund managers, it was noted that there was a clear distinction between portfolio investments and FDI. The basic presumption is that FIIs are not interested in management control. To allay fears of management control being exercised by portfolio investors, it was noted that adequate safety nets were in force, for example (a) transaction of business in securities on the stock exchanges are only through stock brokers who have been granted a certificate by SEBI, (b) every transaction is settled through a custodian who is under obligation to report to SEBI and RBI for all transactions on a daily basis, (c) provisions of SEBI
(substantial acquisition of shares and takeovers) Regulations 1997, and (d) monitoring of sectoral caps by RBI on a daily basis.

(C). There is often a popular preference for FDI over FII on the assumption that FIIs are fair-weather friends who came when there is money to be made and leave at the first sign of impending trouble. FDI, by contrast have a lasting interest in their company and stay with it through thick or thin. While there is some justified strength in this preference, some further arguments need to be taken into account while exercising the choice. First, all portfolio investors, whether domestic or foreign are fair weather friends and exit as soon as there is evidence that they will lose money by staying invested in particular company. Extending the logic of FDI over FII leads to the prescription of preferring strategic domestic investors over domestic portfolio investors. Second, the strength of domestic home-grown entrepreneurship in India is widely acknowledged. Because of this strength, some commentators describe the Indian growth process as an organic one. This entrepreneur class may prefer to have portfolio investors who share the project and business risk without interfering in the critical management decisions of the company. Thus, there may be a preference for FII over FDI as far as this class is concerned. This preference has a close analogy with the choice between allowing a strategic investor to have management control in a public sector company and allowing a diversified mutual fund to hold a large part of the shares of such a company. Finally, if there is an intent to encourage FDI, then this constitutes a case for easing restrictions upon FDI style control oriented purchases by portfolio investors which is done through FII.
(D). Net FDI flows into India have remained small. Either when compared with Indian GDP or when compared to global FDI flows. In contrast with the Chinese experience, relatively little FDI has come into India in setting up factories which are part of global production chains. This may be associated with infirmities of Indian indirect taxes and transportation infrastructure. India is more important as a platform for services production as a part of global production chains, where difficulties of indirect taxes and transportation infrastructure are less important. However, services production is less capital intensive, and induces smaller net FDI flows. Given the size of the Indian economy, and the relative lack of correlation with the global business cycle, Indian equities have had low correlations with global risk factors. In addition India has fared well in creating the Institutional mechanism of a modern, liquid equity market; Through these factors portfolio flows have predominated. India’s share in global portfolio flows is higher than India’s share in global FDI flows, and net portfolio flows are substantial when compared to Indian GDP (Shah and Patnaik, 2004).

**Sectoral Caps on FIIs:**

Foreign institutional investors are permitted to invest in the primary market and secondary capital markets in India by a way of Portfolio Investment Scheme (PIS) under which FIIs can acquire shares/debentures of Indian companies through the stock exchanges of India. The overall investment ceiling for FIIs is 24 percent of the paid capital of the Indian company. This limit is set as 20 percent of the paid up capital in case of public sector banks, including the State Bank of India. However, this ceiling of 24 percent can be raised up to sectoral cap/statutory ceiling, provided
Foreign investments in the form of FIIs are allowed in most of the sectors in the Indian economy, with certain exceptions. Though the government continues to prohibit or severely restrict FII in certain sectors, various other aspects of foreign investment have been liberalized and do not require approval by the government. There are some of the sectors in which the Government of India permits investments by FIIs.

Applying FDI limits to FII investments was considered as a major setback as far as India's policy framework for foreign portfolio investment was concerned. As a result of the budget speech in 2002-03 suggesting that FII investments would not be subject to the same limit as the FDIs, a committee was constituted under the chairmanship of the Chief Economic Advisor. The committee, which includes representation from department of Economic Affairs and Department of Industrial Policy and Promotion, was required to analyze the applicability or otherwise of the FDI flows.

Following are the important recommendations of the Lahiri committee report on liberalization of foreign institutional investment which are submitted in June 2004:

- Simplification of registration and renewal of FII status.
- As the 24 percent limit on FII investment imposed in 1992 was exclusive of the FDI limit, ceiling limit on FII to be considered in addition to the existing FDI sectoral caps.
• Do away with the procedure pertaining to raising FII investment beyond 24 percent up to the FDI limit in a company by amending the relevant regulations for FIIs by the SEBI.

• The existing cap of 10 percent by a foreign institutional investor in a company to be retained in order to provide dispersed investments and at the same time preventing concentration of ownership.

In addition to the above, certain specific proposals were also made in respect of four sectors. It was suggested that in the telecommunication sector, the composite cap on FDI and FII investment might be increased to 74 percent without separate subceilings. Likewise in defense, a composite cap of 49 percent was suggested with no sub-ceilings for FDI and FII. In case of PSU banks it was suggested that FII investments up to 20 percent in addition to the existing cap of 20 percent is to be allowed wherein a composite cap of 20 percent is applicable. The committee also suggested that the composite cap might be enhanced to 49 percent by making suitable amendments to the relevant statues in insurance companies.

**Special incentives for FIIs in selected sectors of India**

**Power Sector**

The power sector in India has undergone major transformation in terms of structure and form of regulation, thereby paving way to vast expansion opportunities both to the domestic as well as foreign institutional investors. Some of the major initiative undertaken by the government to meet the objective of “Power for all: 2012” including allowing private players, both domestic and foreign, to set up power generation facilities, transmission and distribution, and removing ceilings on
investments by FDIs as well as FIIs. India has undoubtedly emerged as the fifth largest market in the world against eighth position in the last decade. The sector has an installed generation capacity of 123 GW, generates more than 600 billion kWh, and carries out transmission and distribution network of more than 6.3 million circuits kms. Keeping in view, the potential of the Indian power sector in the world power market, the Government of India has spelt out significant policy initiatives to make the investment climate more conducive towards attracting Foreign Investment in the power sector. 100 percent foreign equity participation is permitted under the automatic approval route in all segments of the industry like generation (through coal, gas, or hydro), transmission and retail distribution. In case of large generation projects, the Mega Power Policy also provides incentives like capital import duty concessions, and the waiver of local levies to ease the burden of transaction costs. In addition, all power projects enjoy the benefit of a tax holiday according to which, they are given deduction of 100 percent of profits of the generation, transmission or distribution company, for a period of 10 consecutive years out of 15 years from commencement of the company, or a process involving major renovation of the existing transmission lines, under the Income Tax Act. The policy initiatives are thus aimed at offering maximum benefits in respect of 100 percent foreign investment in all segments of the industry both in terms of fiscal benefits as well as tax holiday.

**Telecommunication Sector**

The telecom sector in India was opened to the private players in the early 80s (termed as phase I). Liberalization of any sector of an economy to competition is generally known to create furor and over expectations about its market potential and
the Indian telecom sector was not expected to be an exception. In its inception phase itself, various operators plunged into the sector to rest the waters. As the II phase of consolidation was carried out in the 90s, the sector had few participants while most others succumbed to the cutthroat competition. The sector had remained as monopoly for quite long with the government-run BSNL and MTNL together accounting for 98% of nationwide exchange lines. However, as other players start operations in fixed line services, with the phase III in progress, it is anticipated that this sector will witness a much tougher competition in the coming years.

Investments by the foreign investors in the telecom sector have been pegged at 49 percent, by the Government on India. This limit of 49% is inclusive of both FIIs and foreign direct investment (FDIs). It is well known fact that the telecom is a capital-intensive sector which necessitates huge long-term investments. It has been rightly recognized by the government working group on telecom sector, for the Tenth Five Year Plan that, in order to achieve the tele-density targets, funding requirement to the tune over Rs.46000 crores would be necessary through private sector investments. As the domestic players may not be in a position to meet such a huge requirement themselves, substantial investments are expected from foreign investors to meet the shortfall.

Taking into view, the prevalent financial condition in India, apart from the state-owned enterprise such as BSNL and MTNL it is next to impossible for other participants of the market either to plan or to actually make such huge outlays regularly over period of time. In addition, as the banks and financial institutions are becoming more risk averse by adopting more conservative and discreet appraisal
procedures, it is believed that huge funds might not be easily available. Hence it is felt that those firms, which enjoy the comfort of free cash flows without too much of debt burden, would have an edge over competitors. As a result, most of the private players would be forced to rely heavily on overseas equity funding through strategic or venture capital investors. However, such a heavy reliance on external support would be subject to selective approval, notwithstanding the fact that India has remained a strong growth attraction in the world market. In such circumstances, a hike in the foreign investments ceiling from the current 49 percent to a composite cap of 74 percent (for both FDI and FII) in November 2005, has definitely proved beneficial in enhancing the investment climate of the Indian telecom sector towards attracting more FIIs.

Insurance Sector
The insurance sector in India was opened to private players – domestic as well as foreign, with the passage of the Insurance Regulatory and Development Authority (IRDA) Bill, in March 2000, thus lifting all entry barriers, with certain limits on direct as well as institutional foreign ownership. According to the current guidelines, there is a 26 percent equity cap for investments by FIIs inclusive of FDI limit, in an insurance company. Global insurers are allowed to set up and register a domestic company in order to carry out their business in India with a capital base of at least US$20 million, with the cap of 26 percent in such company. The foreign players were required to form a joint venture with an Indian partner who was in a position to invest the remaining capital in order to participate in the market. Ever since the enactment of the above IRDA rules, 8 global non-life insurance companies and 13 life
insurance companies gained entry into the Indian Insurance market (Guy Carpenter Views- “The Liberalization of India’s Insurance Industry”.

The government of India announced its intention to make suitable amendments to IRDA law in order to increase the above cap to 49 percent in July 2004. However owing to intense political debate in domestic arena, action regarding the same has been delayed Liberalization of the insurance sector is expected to bring about a greater awareness of the importance of insurance in India besides leading to restructuring and revival of the public sector insurance companies.

**Banking Sector**

Foreign banks are allowed to operate in India through only one of the three channels i.e. as a branch or a wholly owned subsidiary, or an ownership of up to 74 percent in a private Indian bank. Banks in India are to a large extent owned by the government and as a result foreign banks find it extremely difficult to gain entry owing to various regulations. As of September 2004, there were about 35 foreign banks with 217 branches in India. As a part of policy reforms, FDI, FII or portfolio investment and investments by non-resident Indians has been increased to 74 percent from the previous cap of 49 percent. However, a minimum of 26 percent of the paid up capital of the private sector banks is required to be held by resident Indian, as per the regulations.

On an average foreign investors have over one-third ownership in most of the state-owned banks in India. Moreover, in the past two years, FII shareholding has more than doubled in most of the listed nationalized banks, with prime foreign shareholding especially in larger banks. Foreign investors account for more than
one-third of the public shareholding in 12 out of the 16 listed public sector banks. The foreign shareholding in the five major state-owned banks viz., State Bank of India, Canara Bank, Punjab National Bank, Bank of India, Bank of Baroda and Union Bank of India, which account for a 58% market share of nationalized banks in India, is more than 44% of the non-government holding.

**Roads and Highways, Ports and Harbours**

It is well-known fact that a sound transport system is a pre-requisite for sustained overall growth as well as development. The transport system of an economy apart from serving as a vital infrastructural support for the growth process also plays a vital role towards promoting national integration, which is of prime importance, more so, in a large country like ours. It is also supports the cause of development of the backward regions and bringing them on par with the mainstream economy by exposing them to trade an investment. An efficient transport network becomes all the more necessary in a liberalized set-up towards enhancing productivity and competitive efficiency of the country in the world market. In the Indian transport system, FDI up to 100 percent is allowed under automatic route, In projects Pertaining to construction and maintenance of roads, ports and harbours, highways, vehicular bridges, toll roads and vehicular tunnels. The FII limit in these sectors is exclusive of the FDI limit up to the sectoral cap.

**Macro-Economic Impact of FIIis:**

Foreign institutional investors are largely interested in investing in the capital market. Portfolio flows by FIIis provide liquidity to capital markets; this has raised expectations of higher trading volume. Flow of funds has increased the stock prices.
While the investment in primary markets would increase the flow of additional resources for the use by corporations, the investment in primary market reduces the cost of capital.

One of the possible dangers that lies with the portfolio investments is that though it increases the flow of money in the economic system, it may create problems of inflation. The portfolio investment increases the foreign exchange reserves of the RBI. At the end of March 2010, total net cumulative investment by FII amounted to Rs. 388310.31 crores (333482.59 crores in equity investment and 53827.70 crores in debt) (US $ 89332.60 millions). This supply of foreign exchange strengthens rupee against foreign currency, which may ultimately reduce the export competitiveness of Indian commodities. The policy of RBI is to control the appreciation of rupee to maintain the export competitiveness. The RBI purchases foreign currency in order to maintain stability. The excess liquidity may affect the RBI’s policy of limiting money supply. The RBI has been tackling the problem of excess liquidity by its sterilization policy. There is limitation in the RBI’s ability to pursue this policy effectively. The RBI follows this policy of sterilization by selling the government securities to match the increase in foreign exchange assets. There has been a substantial decline of the RBI’s holding of government securities. Thus, the scope of sterilization has become limited. There are some unpleasant consequences of the above developments. Managing the exchange by dampening the Rupee artificially has affected the monetary policy initiatives of central bank. The fiscal policy and monetary policy are imitative, which should supplement each other to achieve consistent macro-economic objectives. But as a result of the RBI’s effort in maintaining the stability of
rupee such monetary policy has been delinked from fiscal policies. Secondly, there may be a drain of foreign exchange as there is a substantial difference between repatriable returns earned by foreign investors and foreign exchange returns earned by the RBI on its investment of its foreign exchanges on relatively liquid resources.
REFERENCES


