CHAPTER – II

CONCEPTS AND REGULATORY FRAMEWORK

This chapter discusses the concepts related to FIIs and the regulatory framework for FIIs to invest in India. This would further support the evidence for the objectives formulated for the research.

2.1 Concepts

Investment

Investment is the employment of funds with the aim of achieving increased growth in the value of existing funds. It is the allocation of monetary resources to procure assets that are expected to increase in value and yield gain or positive return over a period of time.

Capital Market

It is the segment of financial markets in which securities having maturities exceeding one year are traded. Examples include preference shares, equity shares, and debentures.

Stock Market

It is the place where shares are traded. The companies that wish their stocks to be bought or sold list their shares in the Stock Exchange. Members registered in
the stock exchange can buy or sell the stocks on behalf of their investor or client. Based on the growth, demand and supply, and several other factors, the prices of the listed securities change. From experience it is known that investors may temporarily move financial prices away from their long term aggregate price trends. Over-reactions may occur, so that excessive optimism may drive prices unduly high or excessive pessimism may drive prices unduly low. Economists continue to debate whether financial markets are generally efficient.

**Bombay Stock Exchange (BSE)**

Bombay Stock Exchange (BSE) which is one of the oldest in the world and accounts for the largest number of listed companies and has also started a screen-based trading system with the introduction of the Bombay On-Line Trading system. Established in 1875, BSE Ltd. (formerly known as Bombay Stock Exchange Ltd.), is Asia’s first Stock Exchange and one of India’s leading exchange groups. Over the past 137 years, BSE has facilitated the growth of the Indian corporate sector by providing it an efficient capital-raising platform. Popularly known as BSE, the bourse is established as “The Native Share & Stock Brokers Association” in 1875. BSE is a corporatized and demutualised entity, with a broad shareholder-base which includes two leading global exchanges, Deutsche Bourse and Singapore Exchange as strategic partners. BSE provides an efficient and transparent market for trading in equity, debt instruments, derivatives, mutual
funds. BSE also provides a host of other services to capital market participants including risk management, clearing, settlement, market data services and education. It has a global reach with customers around the world and a nationwide presence. BSE’s popular equity index - the S&P BSE SENSEX - is India's most widely tracked stock market benchmark index. It is traded internationally on the EUREX as well as leading exchanges of the BRICS nations (Brazil, Russia, China and South Africa).

There are 23 recognized stock exchanges in India, including the Over the Counter Exchange of India (OTCEI) for small and new companies and the National Stock Exchange (NSE) which was set up as a model exchange to provide nation-wide services to investors. NSE, which in the recent past has accounted for the largest trading volumes, has a fully automated screen based system that operates in the wholesale debt market segment as well as the capital market segment. In countries like India, statutory agencies like SEBI have prescribed norms to register FIIs and also to regulate such investments flowing in through FIIs.

**National Stock Exchange (NSE)**

The National Stock Exchange (NSE) is India’s leading stock exchange covering various cities and towns across the country. NSE is set up by leading institutions to provide a modern, fully automated screen-based trading system with
national reach. NSE is promoted by leading Financial Institutions at the interest of the Government of India and got incorporated in November 1992 as a tax-paying company unlike other stock exchanges in the country. The Exchange has brought about unparalleled transparency, speed & efficiency, safety and market integrity. It has set up facilities that serve as a model for the securities industry in terms of systems, practices and procedures. NSE plays a catalytic role in reforming the Indian securities market in terms of microstructure, market practices and trading volumes. NSE uses state-of-art information technology to provide an efficient and transparent trading, clearing and settlement mechanism, and has witnessed several innovations in products & services viz. demutualization of stock exchange governance, screen based trading, compression of settlement cycles, dematerialization and electronic transfer of securities, securities lending and borrowing, professionalisation of trading members, fine-tuned risk management systems, emergence of clearing corporations to assume counterparty risks, market of debt and derivative instruments and intensive use of information technology. NSE’s flagship index, the CNX Nifty, is used extensively by investors in India and around the world to take exposure to the Indian equities market.

**Stock Market Indices**

An Index is used to give information about the price movements of products in the financial, commodities or any other markets. Financial indexes are constructed to measure price movements of stocks, bonds, T-bills and other forms
of investments. Stock market indexes are meant to capture the overall behaviour of equity markets. A stock market index is created by selecting a group of stocks that are representative of the whole market or a specified sector or segment of the market. An Index is calculated with reference to a base period and a base index value. S&P BSE Sensex and NIFTY are the two major market indices studied.

**BSE SENSEX**

Bombay Stock Exchange Sensitive Index (BSE SENSEX) reflects the price movements of 30 selected shares listed in BSE. SENSEX at any time reflects the aggregate market value of these 30 shares relative to the average aggregate market value in the base year 1978-1979. Standard & Poor (S&P) BSE SENSEX, first compiled in 1986, is calculated on a “Market Capitalization-Weighted” methodology of 30 component stocks representing large, well-established and financially sound companies across key sectors. The base year of S&P BSE SENSEX is taken as 1978-79. S&P BSE SENSEX today is widely reported in both domestic and international markets through print as well as electronic media. It is scientifically designed and is based on globally accepted construction and review methodology. Since September 1, 2003, S&P BSE SENSEX is being calculated on a free-float market capitalization methodology. The “free-float market capitalization-weighted” methodology is a widely followed index construction methodology on which majority of global equity indices are based; all major index providers like MSCI, FTSE, STOXX, and Dow Jones use the
free-float methodology. The growth of the equity market in India has been phenomenal in the present decade. Right from early nineties, the stock market witnessed heightened activity in terms of various bull and bear runs. In the late nineties, the Indian market witnessed a huge frenzy in the ‘TMT’ sectors. More recently, real estate caught the fancy of the investors. S&P BSE SENSEX has captured all these happenings in the most judicious manner. One can identify the booms and busts of the Indian equity market through S&P BSE SENSEX. As the oldest index in the country, it provides the time series data over a fairly long period of time (from 1979 onwards).

CNX Nifty

National Stock Exchange (NSE) in collaboration with Standard & Poor (S&P), a rating agency in US, has developed this index to reflect the price movement of 50 shares listed in NSE. These 50 shares are selected on basis of market capitalization and liquidity. The base price of the index is the closing price on November 3, 1995. Equities trading at NSE began in November 1994. By late 1995, NSE became India’s largest equity market and was looking for a market index to utilize this unique information source. NSE also wanted to have a vehicle for the futures and options market. NSE approached the economists Dr. Ajay Shah and Dr. Susan Thomas, (then at Centre for Monitoring Indian Economy Pvt. Ltd.- CMIE and now at Indira Gandhi Institute of Development Research (IGIDR), to conduct research on methods in index construction and led to
the CNX Nifty (Source: http://www.nseindia.com). The results of this work are remarkably simple: (a) the correct size to use is 50, (b) stocks considered for the CNX Nifty must be liquid by the ‘impact cost’ criterion and (c) the largest 50 stocks that meet the criterion go into the index. The index assigns weightages to index components, and the weight of a stock is proportional to its market capitalization.

**Emerging Markets**

Emerging markets refers to developing countries experiencing rapid growth and industrialization, with some characteristics of a developed market. This includes countries that may be developed markets in the future or were in the past. A country may be changed to a frontier market if it no longer meets the criteria for an emerging market, due to lack of growth. The economies of China (excluding Hong Kong and Macau, as both are developed) and India are considered to be the largest. The equity markets of Latin American, Asian, African and East European countries are collectively known as emerging markets.

**Adjusted Closing Price**

A stocks closing price on any given day of trading that has been amended to include any distributions and corporate actions that occurred at any time prior to the next days open. The adjusted closing price is often used when examining historical returns or performing a detailed analysis on historical returns. When
trading is done for the day on a recognized exchange, all stocks are priced at close. The price that is quoted at the end of the trading day is the price of the last lot of stock that was traded for the day. This is called a stocks closing price. The final stock price that is quoted can be used by investors to compare a stocks performance over a period of time. This period is usually from one trading day to another.

**Stock Market Returns**

Stock Market Returns are the returns that the investors generate out of the stock market. This return could be in the form of profit through trading or in the form of dividends given by the company to its shareholders from time-to-time. Stock Market Returns can be made through dividends announced by the companies. Generally at the end of every quarter, a company making profit offers a part of the kitty to the shareholders. This is one of the source of stock market return one investor could expect. The most common form of generating stock market return is through trading in the secondary market. In the secondary market an investor could earn stock market return by buying a stock at lower price and selling at a higher price.

Stock Market Returns are not fixed ensured returns and are subject to market risks. They may be positive or negative. Stock Market Returns are not homogeneous and may change from investor-to-investor depending on the amount
of risk one is prepared to take and the quality of his Stock Market Analysis. In opposition to the fixed returns generated by the bonds, the stock market returns are variable in nature. The idea behind stock return is to buy cheap and sell dear. But risk is part and parcel of this market and an investor can also see negative returns in case of wrong speculations. Nifty is a price index and hence reflects the returns one would earn if investment is made in the index portfolio. However, a price index does not consider the returns arising from dividend receipts. Only capital gains arising due to price movements of constituent stocks are indicated in a price index. Therefore, to get a true picture of returns, the dividends received from the constituent stocks also need to be factored in the index values. Such an index, which includes the dividends received, is called the Total Returns Index. Total Returns Index reflects the returns on the index arising from (a) constituent stock price movements and (b) dividend receipts from constituent index stocks.

**Market Capitalization**

One of the main arguments of foreign portfolio investment was that Net FII flows improve the market capitalization of the stock market (a large market capitalization of stock market) invites more Net FII flows. Market capitalization also indirectly represents liquidity position of the market. Market capitalization is the aggregate valuation of the company based on its current share price and the total number of outstanding stocks. It is
calculated by multiplying the current market price of the company's share with the total outstanding shares of the company.

**Stock Market Turnover**

The turnover ratio of a stock is a measure of sellers versus buyers of a particular stock. It is calculated by dividing the daily volume of a stock by the "float" of a stock, which is the number of shares available for sale by the general trading public. A high daily volume and low float will result in a relatively high turnover ratio, whereas a low daily volume and high float will produce a relatively low turnover ratio.

**FII / FIIs (Foreign Institutional Investors)**

Foreign Institutional Investor is the term used to denote an investor; it is mostly of the form of an institution or entity who invests money in the financial markets of a country. The term FII is used in India to refer to companies that are established or incorporated outside India, and is investing in the financial markets of India. These investors must register with the Securities & Exchange Board of India (SEBI) to take part in the market. FII is defined as an institution organized outside of India for the purpose of making investments into the Indian securities market under the regulations prescribed by SEBI. ‘FII’ include “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 investments on behalf of a broad-based fund”. FIIs can invest their own funds as well as invest on behalf of their overseas clients registered as such with SEBI. These client accounts that the FII manages are known as ‘sub-accounts’. A domestic portfolio manager can also register as an FII to manage the funds of sub-accounts. India opened its stock market to foreign investors in September 1992, and in 1993, received portfolio investment from foreigners in the form of foreign institutional investment in equities. This has become one of the main channels of FII in India for foreigners.

Foreign Institutional Investor is defined by NSE (National Stock Exchange) as:

i. An institution established or incorporated outside India as a pension fund, mutual fund, investment trust, insurance company, or reinsurance company;

ii. An international or multilateral organization or an agency thereof, or a foreign governmental agency, sovereign wealth fund, or a foreign central bank;

iii. An asset management company, investment manager or advisor, bank, or institutional portfolio manager that is established or
incorporated outside India and proposes to make investments in India on behalf of broad-based funds and its proprietary funds, if any;

iv. A trustee of a trust established outside India who proposes to make investments in India on behalf of broad-based funds and its proprietary funds, if any;

v. University funds, endowments, foundations, charitable trusts, or charitable societies. Broad based fund means a fund that is established or incorporated outside India, which has at least 20 investors with no single individual investor holding more than 49 percent of the shares or units of the fund. If the broad-based fund has institutional investors, then it is not necessary for the fund to have 20 investors. Further, if the broad based fund has an institutional investor who holds more than 49 percent of the shares or units in the fund, then the institutional investor must itself be a broad-based fund.

Sub-account refers to any person who is resident outside India on whose behalf investments are proposed to be made in India by a foreign institutional investor, and who is registered as a sub-account under the SEBI (FII) Regulations, 1995. The applicant for a sub-account can fall into any of the following categories:

i. Broad-based fund or portfolio that is broad-based, incorporated, or established outside India.
ii. Proprietary fund of a registered foreign institutional investor.

iii. Foreign individual who has a net worth of not less than US $ 50 million, holds a valid passport of a foreign country for a period of at least five years, holds a certificate of good standing from a bank, and is the client of the FII for a period of at least three years.

iv. Foreign corporate that has its securities listed on a stock exchange outside India, having an asset base of not less than US $ 2 billion and having an average net profit of not less than US $ 50 million during the three financial years preceding the date of application. A non-resident Indian shall not be eligible to invest as a sub-account.

2.2 FIIs Investment in Secondary Markets

SEBI regulations provide that a foreign institutional investor or sub-account can transact in the Indian securities market only on the basis of taking and giving delivery of securities purchased or sold. However, this does not apply to any transactions in derivatives on a recognized stock exchange. In December 2007, SEBI permitted FIIs and sub-accounts to enter into short selling transactions only in accordance with the framework specified by SEBI. No transaction on the stock exchange can be carried forward and the transaction in securities would be only through a stock broker who has been granted a certificate by SEBI. They have also been allowed to lend or borrow securities in accordance with the framework
specified by the SEBI in this regard. The purchase of equity shares of each company by investing on its own account should not exceed 10 percent of the total issued capital of that company. For a FIIs investing in equity shares of a company on behalf of its sub-accounts, the investment on behalf of each such sub-account should not exceed 10 percent of the total issued capital of that company. In the case of foreign corporate or individuals, each of such sub-accounts should not invest more than five percent of the total issued capital of the company in which such investments are made.

A foreign institutional investor can issue or otherwise deal in offshore derivative instruments (ODI), directly or indirectly, wherein the offshore derivative instruments are issued only to those persons who are regulated by an appropriate foreign regulatory authority, and the ODIs are issued after compliance with ‘know your client’ norms.

**Investment Restrictions for FIIs**

An FIIs can invest only in the following:

i. 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.

ii. Units of schemes floated by domestic mutual funds including the Unit Trust of India, whether listed or not listed on a recognized stock
exchange, or units of schemes floated by a Collective Investment Scheme

iii. Dated government securities

iv. Derivatives traded on a recognized stock exchange

v. Commercial papers

vi. Security receipts

vii. Indian Depository Receipts

In case a foreign institutional investor or a sub-account holds equity shares in a company whose shares are not listed on any recognized stock exchange, and continues to hold the shares after the initial public offering and the listing thereof, such shares would be subject to a lock-in for the same period, if any is applicable to the shares held by a foreign direct investor placed in a similar position, under the policy of the central government relating to foreign direct investment that is currently in force. The total investments in equity and equity-related instruments (including fully convertible debentures, convertible portion of partially convertible debentures, and tradable warrants) made by an FII in India, whether on its own account or on account of its sub-accounts, should not be less than 70 percent of the aggregate of all the investments. The Reserve Bank of India (RBI) monitors the investment position of FIIs in listed Indian companies, as reported by the custodian.
Reporting of FIIs Investments in India

An FIIs may invest in a particular share issue of an Indian company under either the FDI scheme or the Portfolio Investment Scheme. The AD Category-I banks have to ensure that the FIIs who are purchasing the shares by debit to the Special Non-Resident Rupee Account, report these details separately in the Form LEC (FII). In the case of issue by private placement, the price is not less than the price arrived at in terms of the SEBI guidelines or the guidelines issued by the erstwhile Controller of Capital issues as applicable. Purchases can also be made of partially convertible debentures, fully convertible debentures, and rights or renunciations or warrants or units of domestic mutual fund schemes.

2.3 Regulatory Framework for FIIs Investment in India

Until the 1980s, India’s development strategy was focused on self-reliance and import-substitution. Current account deficits were financed largely through debt flows and official development assistance. There was a general disinclination towards foreign investment or private commercial flows. Since the initiation of the reform process in the early 1990s, however, India’s policy stance has changed substantially, with a focus on harnessing the growing global foreign direct investment (FDI) and portfolio flows. After the launch of the reforms in the early 1990s, there was a gradual shift towards capital account convertibility. From September 14, 1992, FIIs and overseas corporate bodies (OCBs) were permitted to
invest in financial instruments, with suitable restrictions. The guidelines were suitably incorporated under the SEBI (FIIs) Regulations, 1995. These regulations continue to maintain the link with the government guidelines through a clause that was added to the effect that the investment by FIIs should also be subject to government guidelines. This linkage has allowed the government to indicate various investment limits, including those in specific sectors. With the Foreign Exchange Management Act (FEMA), 1999 coming into force in 2000, the Foreign Exchange Management (Transfer or Issue of Security by a Person Resident outside India) Regulations, 2000 were issued to provide the foreign exchange control context where foreign exchange-related transactions of FIIs were permitted by the RBI.

Since 1992, FIIs have been allowed to invest in all securities traded on the primary and secondary markets, including shares, debentures, and warrants issued by companies that were listed or were to be listed on the stock exchanges in India and in schemes floated by domestic mutual funds. Evolution of the policy towards foreign institutional investments is summarized below (Source: SEBI, 2011):

September 1992 - FIIs allowed investing by the government guidelines in all securities in primary and secondary markets as well as in schemes floated by mutual funds. Single FIIs to invest 5 percent and all FIIs allowed investing 24 percent of a company’s issued capital. Broad based funds to have 50 investors with no one holding more than 5 percent. The objective was to have reputed
foreign investors, such as pension funds, mutual funds, or investment trusts and other broad-based institutional investors in the capital market.

**April 1997** - Aggregated limit for all FIIs increased to 30 percent, subject to special procedure and resolution. The objective was to increase the participation by FIIs.

**April 1998** - FIIs permitted to invest in dated government securities subject to a ceiling. Consistent with the government policy to limit the short-term debt, a ceiling of US $1 billion was assigned, which was increased to US $1.75 billion in 2004.

**June 1998** - Aggregate portfolio investment limit of FIIs and NRIs / PIOs / OCBs enhanced from 5 percent to 10 percent, and the ceilings made mutually exclusive.

**June 1998** - Forward cover allowed in equity.

**February 2000** - Foreign firms and high net worth individuals permitted to invest as subaccounts of FIIs. Domestic portfolio manager allowed to be registered as FIIs to manage the funds of sub-accounts. The objective was to allow operational flexibility and also to give access to domestic asset management capability.

**March 2001** - FII ceiling under special procedure enhanced to 49 percent. The objective was to increase FII participation.

**September 2001** - FII ceiling under special procedure rose to sectoral cap.
December 2003 - The FII dual approval process of the SEBI and the RBI changed to a single approval process of the SEBI. The objective was to streamline the registration process and reduce the time taken for registration.

November 2004 - Outstanding corporate debt limit of US $ 0.5 billion prescribed. The objective was to limit short-term debt flows.

April 2006 - Outstanding corporate debt limit increased to US $ 1.5 billion. The limit on investment in government securities was enhanced to US $ 2 billion. This was announced in the budget of 2006–2007.

November 2006 - FIIs investment up to 23 percent permitted in market infrastructure institutions in the securities markets, such as stock exchanges, depositories, and clearing corporations. This was a decision taken by the government following the mandating of demutualization and corporatization of stock exchanges.

January and October 2007 - FIIs allowed to invest US $ 3.2 billion in government securities (limits were raised from US $ 2 billion in two phases of US $ 0.6 billion each in January and October).

June 2008 - While reviewing the External Commercial Borrowing policy, the government increased the cumulative debt investment limits from US $ 3.2 billion to US $ 5 billion and from US $ 1.5 billion to US $ 3 billion for FIIs investments in government securities and corporate debt, respectively.
**October 2008** - While reviewing the External Commercial Borrowing policy, the government increased the cumulative debt investment limits from US $ 3 billion to US $ 6 billion for FIIs investments in corporate debt. Removal of regulation for FIIs pertaining to the restriction of 70:30 ratio of investment in equity and debt, respectively. Removal of restrictions on Overseas Derivatives Instruments (ODIs).

**March 2009** - Disapproval of FIIs lending shares abroad. E-bids platform for FIIs.

**August 2009** - FIIs allowed to participate in interest rate futures.

**April 2010** - FIIs allowed to offer domestic government securities and foreign sovereign securities with AAA rating as collateral (in addition to cash) to recognized stock exchanges in India for their transactions in the cash segment of the market.

**November 2010** - Investment cap for FIIs increased by US $ 5 billion each in government securities and corporate bonds to US $ 10 billion and US $ 20 billion, respectively.

**March 2011** - The limit of US $ 5 billion in corporate bonds issued by companies in the infrastructure sector with a residual maturity of over five years increased by an additional limit of US $ 20 billion, taking the total limit to US $ 25 billion.
As is evident from the above summary, the evolution of the FII policy in India has displayed a steady and cautious approach to the liberalization of a system of quantitative restrictions (QRs). The policy liberalization has taken the form of - the relaxation of investment limits for FIIs; the relaxation of the eligibility conditions; and the liberalization of the investment instruments accessible to FIIs. 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. 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.
Procedure for Registration of FII

The Procedure for registration of FII has been given by SEBI regulations. It states- “no person shall buy, sell or otherwise deal in securities as a Foreign Institutional Investor unless he holds a certificate granted by the Board under these regulations”. An application for grant of registration has to be made in Form A, the format of which is provided in the SEBI (FII) Regulations, 1995.

The eligibility criteria for applicant seeking FII registration is as follows:

Good track record, professional competence and financial soundness.

- Regulated by appropriate foreign regulatory authority in the same capacity/category where registration is sought from SEBI.
- Permission under the provisions of the Foreign Exchange Management Act, 1999 (FEMA) from the RBI.
- Legally permitted to invest in securities outside country or its incorporation / establishment.
- The applicant must be a ‘fit and proper’ person.
- Local custodian and designated bank to route its transactions.
Regulation Relating to FII Operation

Regulations include the limitations or restrictions given to FII for operation in India by the regulatory bodies and are listed below.

- Investment by FIIs is regulated under SEBI (FII) Regulations, 1995 and Regulation 5(2) of FEMA Notification No.20 dated May 3, 2000. SEBI acts as the nodal point in the entire process of FII registration. FIIs are required to apply to SEBI in a common application form in duplicate. A copy of the application form is sent by SEBI to RBI along with their 'No Objection' so as to enable RBI to grant necessary permission under FEMA.

- RBI approval under FEMA enables a FII to buy/sell securities on stock exchanges and open foreign currency and Indian Rupee accounts with a designated bank branch.

- FIIs are required to allocate their investment between equity and debt instruments in the ratio of 70:30. However, it is also possible for an FII to declare it a 100 % debt FII in which case it can make its entire investment in debt instruments.

- All FIIs and their sub-accounts taken together cannot acquire more than 24 % of the paid-up capital of an Indian Company. Indian Companies can raise the above mentioned 24 % ceiling to the Sectoral Cap / Statutory Ceiling as applicable by passing a resolution by its Board of Directors followed by
passing a Special Resolution to that effect by its General Body. Further, in 2008 amendments were made to attract more foreign investors to register with SEBI, these amendments are:

- The definition of “broad based fund” under the regulations was substantially widened allowing several more sub accounts and FIIs to register with SEBI.
- Several new categories of registration viz. sovereign wealth funds, foreign individual, foreign corporate etc. were introduced,
- Registration once granted to foreign investors was made permanent without a need to apply for renewal from time to time thereby substantially reducing the administrative burden,
- Also the application fee for foreign investors applying for registration has recently been reduced by 50 % for FIIs and sub accounts.

Also, institutional investors including FIIs and their sub-accounts have been allowed to undertake short-selling, lending and borrowing of Indian securities from February 1, 2008.

**Policy Developments**

While announcing the policy measures relating to the Government securities market in the credit policy announcement an April 29, 1998. The RBI allowed FIIs to invest in treasury bills within the overall approved debt ceiling. A
previous amendment in 1997 had permitted FIIs to invest in proprietary funds and also to invest in dated government securities. The Finance Minister in his budget speech for 1998-1999 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 FIIs to enter into secondary market transactions only through stockbrokers registered with SEBI. To facilitate the participation of FIIs in open offers, the FIIs 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 FIIs are potential participants in the derivatives markets; it was felt that the presence of FIIs and domestic institutions would be crucial to the success of the market. It was therefore, decided to permit FIIs 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.

I. Allocation of government debt & corporate debt investment limits to FIIs: The SEBI (vide its circular dated November 26, 2010) made the following decisions:
a) **Increased investment limit for FIIs in government and corporate debt:**

In an attempt to enhance FIIs investment in debt securities, the government increased the limit of FIIs investment in government securities by US $ 5 billion, raising the cap to US $ 10 billion.

b) **The time period for the utilization of the debt limits:** In July 2008, SEBI has decided that the time period for the utilization of the corporate debt limits allocated through the bidding process (for both old and long-term infra limit) shall be 90 days. However, the time period for the utilization of the government debt limits allocated through the bidding process shall remain 45 days.

c) **Government debt long terms:** The SEBI, vide its circular dated February 2009, had decided that no single entity shall be allocated more than Rs. 10,000 crore of the investment limit. In a partial amendment to this, the SEBI (vide its circular dated November 26, 2010) has decided that no single entity shall be allocated more than Rs. 2000 crore of the investment limit.

d) **Corporate debt (Old limit):** SEBI has decided that no single entity shall be allocated more than Rs. 600 crore of the investment limits. Where a single entity bids on behalf of multiple entities, such bids would be limited to Rs. 600 crore for every such single entity.

e) **Multiple bid orders from a single entity:** The SEBI has allowed bidders
to bid for more than one entity in the bidding process provided: it provides due authorization from those entities to act in that capacity; it provides the stock exchanges with the allocation of the limits.

f) **FIIs investment into debt securities that are to be listed:** The market regulator has decided that FIIs will be allowed to invest in primary debt issues only if the listing is committed to be done within 15 days.

II. **Maintenance of Collateral by FIIs for Transactions in the Cash Segment:** RBI in consultation with the Government of India and the SEBI has decided (vide its circular dated April 12, 2010) to permit FIIs to offer domestic government securities and foreign sovereign securities with AAA rating as collateral to the recognized stock exchanges in India, in addition to cash, for their transactions in the cash segment of the market.

III. **Reporting of Lending of Securities bought in the Indian Market SEBI:** It has decided (vide its circular dated June 29, 2010) that the FIIs’ reporting of the lending of securities bought in the Indian market will be done on a weekly basis instead of the former practice of daily submissions. In accordance with this change in the periodicity of the reports, FIIs are required to submit the reports every Friday, with effect from July 02, 2010. Further, in view of the change in the periodicity of the reporting, the PN issuing the FIIs are required to submit the undertaking along with the weekly report.
IV. **FII participation in Interest Rate Futures.** The FII have been allowed to participate in the interest rate futures that were introduced for trading at the NSE on August 31, 2009.

V. **FII Investment in Corporate Bonds Infra Long-term Category**

David et al. (2005) examined that the Indian government established a regulatory framework for three separate investment avenues: foreign direct investment; investment by foreign institutional investors; and investment by foreign venture capital investors. While these investment alternatives created clear avenues for foreign investment in India, they remain subject to many conditions and restrictions which continue to hamper foreign investment in India.

Bose and Coondoo (2005) examined the impact of reforms of the foreign institutional investors (FIIs) investment policy, on FII portfolio flows to the Indian stock markets, an aspect, studied on determinants of FII flows to India so far not taken into consideration. FIIs have been allowed to invest in the domestic financial market since 1992; the decision to open up the Indian financial market to FIIs portfolio flows was influenced by several factors such as the disarray in India's external finances in 1991 and a disorder in the country's capital market. Aimed primarily at ensuring non-debt creating capital inflows at a time of an extreme balance of payment crisis and at developing and disciplining the nascent capital market, foreign investment funds were welcomed to the country. Analysis
also helps to evaluate the impact of liberalization policies as well as measures for strengthening of policy framework for FII flows, in the post-Asian crisis period.

### 2.4 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 loss 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
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.

2.5 Expected Gains of FIIs Investment

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

(1) 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 FIIs investment (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.

(2) 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 FIIs 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 (2001), 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.

(3) Improved Corporate Governance

Good corporate governance is essential to overcome the principal-agent problem between share-holders and management. Information asymmetries and incomplete contracts between share-holders 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 are needed are 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. FIIs 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, Rejie 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, 2000).

(4) 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.

(5) Reduced Cost of Equity Capital

FIIs 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. FIIs 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 et al. 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.

(6) 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 (2008) 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.

(7) 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.
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 FIIs are said to have seen instrumental in promoting market efficiency and transparency (Chopra et al., 1995). The argument, in favor of this conclusion, is that the advent of FIIs 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 FIIs investment.