CHAPTER IV

REGULATORY FRAMEWORK FOR FOREIGN INSTITUTIONAL INVESTMENTS IN INDIAN CONTEXT

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Chapter IV

Regulatory Framework for Foreign Institutional Investments in Indian Context

4.1 Introduction

The economic reform process in India commenced in the early 1990s with the objectives of controlling the balance of payment crisis, and accessing the increasing global foreign direct investment and portfolio flows. On September 14, 1992, the policy framework to permit FII investment in Indian financial instruments under the foreign portfolio investment (FPI) scheme was provided by the Government of India’s guidelines. Under these guidelines, Foreign Institutional Investors including institutions such as Pension Funds, Mutual Funds, Investment Trusts, Asset Management Companies, Nominee Companies and Incorporated/Institutional Portfolio Managers to their power of attorney holders (providing discretionary and non-discretionary portfolio management services) were allowed to make investments in all the securities traded on the Primary and Secondary markets, inclusive of the equity and other securities/instruments of companies which were listed or to be listed on the stock Exchanges in India, including the Over The Counter Exchange of India (OTCEI). They were allowed to invest in shares, debentures, warrants, and the schemes floated by domestic Mutual Funds.

Before making any investment in Indian Stock Exchanges, FIIs had to initially register with Securities and Exchange Board of India (SEBI), which is the nodal regulatory agency for securities markets in India. Nominee companies, affiliates and subsidiary companies of a FII were to be treated as separate FIIs for registration and had to separately register with SEBI. It framed a set of criteria, like professional competence, financial soundness and experience,
required to be satisfied by the applicant FIIs for being granted registration. Additionally, FIIs seeking initial registration with SEBI were required to hold a registration from the Securities Commission, or the regulatory organisation for the stock market in the country of domicile / incorporation of the FII.

FIIs had to also obtain Reserve Bank of India’s (RBI) general permission under the Foreign Exchange Regulation Act (FERA), which would enable them to buy, sell, and realize capital gains on investments made through an initial corpus remitted to India, to invest on all recognized stock exchanges through a designated bank branch, and to appoint domestic custodians for the investments held. RBI’s general permission under FERA also allowed the FIIs to repatriate capital, capital gains, dividends, incomes received by way of interest, etc. and any compensation received towards sale/renouncement of rights offerings of shares, subject to the designated branch of a bank/the custodian being authorised to deduct withholding tax on capital gains and arranging to pay such tax and remitting the net proceeds at market rates of exchange. Initial registration from SEBI and RBI’s general permission under FERA were to be valid for five years, which on expiry were renewable for similar five year periods.

For the purpose of entry, the FIIs were restricted by neither any floor/ceiling, nor by any lock-in-period for investments made by them in primary or secondary market. As the rates of taxation on short term capital gains were much higher than those on long term capital gains, the differential was expected to be enough incentive for motivating the FIIs to retain their investments for long term. The holding of a single FII and total holding of all registered FIIs in any one company were subject to a limit of 5% and 24% respectively of the company’s total issued share capital. For this purpose, the total holding of an FII group was to be counted as the holding of a single FII. Moreover, the same 24% ceiling was applicable for all
non-resident portfolio investments inclusive of NRI corporate and non-corporate investments, but excluding foreign investments under financial collaborations (direct foreign investments) which were permitted up to 51% in all priority areas. Investments by FIIs were allowed through three routes – (i) Offshore single/regional Funds, (ii) Global Depository Receipts (GDR) and (iii) Euroconvertibles. FIIs were allowed to disinvest only through stock exchanges in India, including the OTCEI. For exceptional cases, SEBI reserved the power to permit sales other than through stock exchanges, only if the sale price was not significantly different from the stock market quotations, where available. FIIs investing under this scheme were put under a concessional tax regime of a flat rate tax of 20% on dividend and interest income and a tax rate of 10% on long term (one year or more) capital gains.

It is in the above backdrop that the present chapter critically analyses the regulatory framework for FIIs in Indian context.

4.2 SEBI (FIIs) Regulations (1995) and Periodic Modifications

The Government guidelines of 1992 were incorporated under the SEBI (FIIs) Regulations, 1995, and in order to allow the government to indicate various investment limits, inclusive of various sector specific limits, a clause was added that the investments made by FIIs should also be subject to government guidelines. SEBI (FIIs) Regulations, 1995 also permitted 100% debt funds to invest as FIIs or as sub-accounts of FIIs within the overall external commercial borrowing limit fixed by the government. Introduction of this comprehensive set of laws governing FII flows paved the path for more portfolio investments in India. During 1992-93, the FII flows were a meagre INR 130 million (ref. Figure 4.1). The next financial year witnessed a sharp increase to INR 51,270 million. Thereafter, the net FII inflows dipped to INR 47,960 million in 1994-95. Strong fundamentals of Indian economy, expectations of a stable exchange rate, incentives offered and congenial climate for FII investments provided
the edge to benefit from overheated international capital markets, and as a result net FII flows for the year 1995-96 soared to INR 69,420 million.

Figure 4.1

Trend in FII Investment (Net) in India: Debt and Equity (INR Millions)

Data Source: SEBI

In October, 1996 a few significant regulatory changes were adopted to attract greater amount of foreign portfolio investments. With an aim of increasing the number of investors, University fund, endowments, foundations or charitable trusts and charitable societies were considered eligible for being registered as FIIs, even though they were not regulated by a foreign regulatory authority. All the FIIs were also allowed to invest in shares, debentures and warrants of companies not listed on a recognised stock exchange in India. Equity share investment limits on own account and on behalf of subaccounts were increased from 5 percent to 10 percent of total capital issued by a company. Custodians of FIIs were asked to become members of the clearing houses or clearing corporations of the stock exchanges and participate in the clearing and settlement process for all securities through them. The net FII
flows in equity for the year grew as a result to reach INR 85,460 million and the net FII flows in debt were INR 290 million.

In 1997-98, measures were taken to further facilitate investments by FIIs. To increase the participation by FIIs, in April 1997, aggregate limit for all FIIs was increased to 30 per cent of a company’s issued capital subject to special procedure and resolution. In spite of measures adopted for enhancing FII investments and partial immunity of Indian economy from contagion, the impact of South-East Asian financial crisis on FII flows was visible as net FII inflows in equity in 1997-98 fell by 38.37 percent to INR 52,670 million, but the same in debt went up to INR 6,910 million. In April 1998, dated Government securities market were opened up for FII investments subject to a ceiling, and in keeping harmony with the Government policy to limit the short-term debt, a ceiling of US $ 1 billion was approved. In June 1998, aggregate portfolio investment limit of FIIs and Non Resident Indians (NRIs) / Persons of Indian Origin (PIOs) / Overseas Corporate Bodies (OCBs) was increased from 5 per cent to 10 per cent, and the ceilings were made mutually exclusive. Separate ceilings were prescribed to avoid negation of permission to FIIs made earlier due to the common ceiling. In the same month, FIIs were allowed to invest in unlisted companies through the 100 percent debt route. FIIs investing through this route were permitted by the Reserve Bank of India to hedge their foreign exchange exposure by taking forward cover, and also to buy and sell exchange traded index futures contracts while being exempted from giving or taking delivery. Despite the policy changes to ease and motivate FII investments, test explosion of nuclear bombs in Pokhran in May 1998 prompted the major suppliers of FII investments, such as US, Japan and other industrialised countries, impose economic sanctions on India. As a result, Indian economy witnessed a net FII outflow for the first time (INR 7,170 million and INR 8,670 million in equity and debt respectively) but recovered fast and posted
unprecedented net inflows for the next three years on account of low volatility, attractive valuations of securities and a stable currency.

After Foreign Exchange Management Act (FEMA) was enacted in 1999, 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. A policy of preference for institutional funds, prohibiting portfolio investments by foreign natural persons was followed. Only Non-resident Indians were permitted for direct participation by individuals. From the same year, foreign firms and high net worth individuals were permitted to invest as sub-accounts of SEBI-registered FIIs. FIIs were also allowed to seek registration from SEBI for sub-accounts of their clients. While initially, only FIIs were permitted to manage the sub-account of clients, from the year 2000 the domestic portfolio managers and domestic asset management companies were also permitted to manage the funds of sub-accounts of FIIs. Such sub-accounts could be an institution, or a fund, or a portfolio established or incorporated outside India, a broad-based fund, a proprietary fund, or even a foreign corporate or individual. The sub-accounts were not permitted to invest directly, but through FIIs, domestic portfolio managers or asset management companies. Although from 1992, to ensure a broad base of foreign investors and prevent FII investments being used as a camouflage for individual investment in the nature of FDI requiring Government approval, funds invested by FIIs were required to have at least 50 participants with no single participant holding more than 5 per cent; the requirement was revised to 20 investors in August, 1999. With the objective of increasing FII participation, the ceiling for a single participant was raised to 10 percent in February, 2000, and the FII ceiling was enhanced to 49% in two phases during the years 2000 and 2001. In September 2001, RBI permitted Indian companies to increase the FII investment limit up to the sectoral cap/statutory ceiling, as applicable. The years 1999-2000,
2000-01 and 2001-02 observed phenomenal net FII inflows of INR 101,230 million (net inflows of INR 96,700 million in equity and INR 4,530 million in debt), INR 99,340 million (INR 102,070 million net inflow in equity and INR 2,730 million net outflow in debt) and INR 87,620 million (net inflows of INR 80,720 million in equity and INR 6,900 million in debt) respectively. A dip of 69% in net inflow to INR 26,890 million (net inflows of INR 25,270 million in equity and INR 1,620 million in debt) in 2002-03 was experienced due to global economic uncertainty caused by the Afghan war.

In the month of December 2003, implementing the recommendation of the Working Group for Streamlining of the Procedures relating to FIIs, the dual approval process of the SEBI and the RBI was changed to a single approval process of the SEBI to streamline the registration process and reduce the time taken for registration of the FIIs. Robust growth of Indian economy and attractive valuations in the Indian equity markets, as compared with other Asian emerging economies, along with the renewed ease of FII investments prompted the international investors to pour in funds to the Indian equities as a part of their global portfolio readjustment process. The net FII inflow for the year 2003-04 skyrocketed to INR 457,650 million (INR 399,600 million in equity and INR 58,050 in debt), up by over 1600 percent from INR 26,890 million in the previous year.

In November 2004, to limit short term debt flows, an outstanding corporate debt limit of USD 0.5 billion was prescribed. Despite a short slowdown during the first quarter of 2004-05 due to global economic uncertainties caused by steep rise in crude oil prices and the upturn in the interest rate cycle, FIIs invested heavily in Indian equities during 2004-05 and 2005-06 (INR 441,230 million and INR 488,010 million respectively), but net inflows into debt securities dipped to INR 17,590 million in 2004-05 and turned negative (a net outflow of INR 73,340 million) in 2005-06. During April 2006, the outstanding corporate debt limit was raised to
USD 1.5 billion and the limit on investment in Government securities was enhanced to USD 2 bn. In November 2006, FII investment up to 23% was permitted in infrastructure companies in the stock exchanges, depositories and clearing corporations. It was a decision taken by the Government following the mandating of demutualization and corporatization of stock exchanges. 2006-07 witnessed a slowdown in FII investment in equity following meltdown in global commodity and equity markets inclusive of Asian equity markets, tightening of capital controls in Thailand and its spill over effects. During the year, FIIs made a net investment of INR 252,360 million and INR 56,050 million in equity and debt respectively.

During 2007, FII investment limit in Government securities was increased in two phases of USD 0.6 billion each to reach USD 3.2 billion. In June 2008, the Government again raised the cumulative debt investment limits from USD 3.2 billion to USD 5 billion, and USD 1.5 billion to USD 3 billion for FII investments in Government Securities and Corporate Debt, respectively. Three important policy changes were made in October 2008. The cumulative debt investment limits in corporate debt for FII investments were further increased to USD 6 billion. Earlier, regular FIIs were required to invest not less than 70 per cent of their investment in equity related instruments, and up to 30 per cent in non-equity instruments. This regulation for FIIs pertaining to restriction of 70:30 ratio of investment in equity and debt respectively was removed. Restrictions on Overseas Derivatives Instruments (ODIs) were also lifted during the same month. During 2007-08, Indian corporates raised large resources through 85 initial public offerings (IPOs) and 7 follow on public offers (FPOs) aggregating to INR 545,110 million. Increased participation of FIIs in the primary market contributed towards a large net inflow of INR 534,040 million, and INR 127,750 million in equity and debt respectively.
During 2008-09, the major sources of FII flows were dried up due to the credit crisis across the developed economies which also affected the emerging economies. Plunging FII inflows and soaring outflows led to a net outflow of INR 477,060 million from equities, whereas net inflow in debt securities were down to INR 18,950 million for the year. In August 2009, FIIs were permitted to participate in interest rate futures. Relative resilience of the Indian economy and strong fundamentals backed by domestic demand attracted record equity investment of INR1,149,010 million by FIIs in 2009-10, and kept the momentum continuing for the next year as well. In April 2010, FIIs were allowed to offer domestic Government securities and foreign sovereign securities with AAA rating, as collateral to the recognised stock exchanges in India, in addition to cash, for their transactions in the cash segment of the market. In November 2010, with the objective of enhancing FII investment in debt securities, investment cap for FIIs in Government securities and corporate bonds was increased to USD 10 billion and USD 20 billion respectively. In March 2011, the limit of US $ 5 billion in corporate bonds, with a residual maturity of over five years and issued by companies in the infrastructure sector, was increased to USD 25 billion. In the Budget 2011-12, the Government of India allowed qualified foreign investors (QFIs), who comply with the Know Your Customer (KYC) norms, to directly invest for the first time in Indian capital market, but only through equity mutual fund (MF) schemes and MF debt schemes that invest in infrastructure. In January 2012, this scheme was expanded to permit QFIs to directly invest in Indian equity markets, and next year to invest in corporate bonds in India. Despite all the measures taken to further enhance FII investment in Indian capital markets, subdued Indian equity markets witnessed a 60 percent drop in FII investments in equity during 2011-12 owing to deepening crisis in Euro area, weak macroeconomic indicators and depreciation of rupee. FII net inflows in debt during the year went up by 38% to reach INR 499,880 million. Net FII inflows to Indian equity created yet another high of INR1,400,330 million, whereas
Net FII inflows to Indian debt market was INR 283,340 million during 2012-13. The surge in FII investments witnessed in 2014-15 could be attributed to SEBI (FPI) Regulations 2014, which are elaborated in the next section.

4.3 SEBI (Foreign Portfolio Investors) Regulations, 2014

In accordance with the guidance of Working Group on Foreign Investment (WGFI), which was set up by the Ministry of Finance in 2010 with an objective of simplifying and promoting foreign portfolio investments, SEBI constituted a committee in December 2012, under the Chairmanship of K.M. Chandrasekhar. In harmony with policy announcements by the Finance Minister in his Budget 2013 speech and Chandrasekhar Committee recommendations, SEBI charted the SEBI (Foreign Portfolio Investors) Regulations, 2014 (popularly known as FPI Regulations), which replaced the SEBI (Foreign Institutional Investor) Regulations, 1995, and also the Qualified Foreign Investors (QFI) framework. Thus, effective from June 2014, SEBI introduced a new class of foreign investors in India known as the Foreign Portfolio Investors (FPIs) by merging three of the existing classes of foreign investors - Foreign Institutional Investors (FIIs), Qualified Foreign Investors (QFIs) and sub-accounts of the FIIs. Although the number of SEBI-registered FIIs declined by 16% to 1,444 in 2014–2015 from 1,710 in the previous year, the monthly trend in FII investments in 2014–2015 (ref. Figure 4.2) shows positive net FII investments for all the months, implying upbeat investor sentiment and India’s emergence as a popular investment destination. The net FPI investments rose four times in 2014–2015 in comparison to the same in 2013–2014. The net FII investment in equity for the year surged by 40% to reach INR 1,113,330 million (from INR 797,090 in 2013-14), as against a decline of 43% in the previous fiscal year. The net investment by FIIs in debt segment during 2014–2015 was INR 1,661,270 million as against a net outflow of INR 280,600 million in 2013–2014.
The key provisions of SEBI (Foreign Portfolio Investors) Regulations, 2014, are discussed below.

**Foreign Portfolio Investor (FPI)**

“Foreign Portfolio Investor” means a person who satisfies the eligibility criteria prescribed under regulation 4 of the SEBI (Foreign Portfolio Investors) Regulations, 2014, and has been registered under Chapter II of these regulations, who shall be deemed to be an intermediary in terms of the provisions of the Act, provided that, any foreign institutional investor or qualified foreign investor who holds a valid certificate of registration shall be deemed to be a foreign portfolio investor till the expiry of the block of three years for which fees have been paid as per the Securities and Exchange Board of India (Foreign Institutional Investors) Regulations, 1995.
Eligibility Criteria for FPI

The designated depository participant shall not consider an application for grant of certificate of registration as a foreign portfolio investor unless the applicant satisfies the following conditions:

(a) the applicant is a person not resident in India;

(b) the applicant is resident of a country whose securities market regulator is a signatory to International Organization of Securities Commission’s Multilateral Memorandum of Understanding or a signatory to bilateral Memorandum of Understanding with SEBI;

(c) the applicant, being a bank, is a resident of a country whose central bank is a member of Bank for International Settlements;

(d) the applicant is not resident in a country identified in the public statement of Financial Action Task Force as:

   (i) a jurisdiction having a strategic Anti-Money Laundering or Combating the Financing of Terrorism deficiencies to which counter measures apply;

   or

   (ii) a jurisdiction that has not made sufficient progress in addressing the deficiencies or has not committed to an action plan developed with the Financial Action Task Force to address the deficiencies;

(e) the applicant is not a non-resident Indian;

(f) the applicant is legally permitted to invest in securities outside the country of its incorporation or establishment or place of business;

(g) the applicant is authorized by its Memorandum of Association and Articles of Association or equivalent document(s) or the agreement to invest on its own behalf, or on behalf of its clients;
(h) the applicant has sufficient experience, good track record, is professionally competent, financially sound and has a generally good reputation of fairness and integrity;

(i) the grant of certificate to the applicant is in the interest of the development of the securities market;

(j) the applicant is a fit and proper person based on the criteria specified in Schedule II of the Securities and Exchange Board of India (Intermediaries) Regulations, 2008, and

(k) any other criteria specified by SEBI from time to time.

**Categories of foreign portfolio investor**

An applicant may apply for registration as a foreign portfolio investor in one of the following categories or any other category as may be specified by SEBI from time to time:

(a) "Category I foreign portfolio investor" which shall include Government and Government related investors such as central banks, Governmental agencies, sovereign wealth funds and international or multilateral organizations or agencies;

(b) "Category II foreign portfolio investor" which shall include:

   (i) appropriately regulated broad based funds such as mutual funds, investment trusts, insurance/reinsurance companies;

   (ii) appropriately regulated persons such as banks, asset management companies, investment managers/ advisors, portfolio managers;

   (iii) broad based funds that are not appropriately regulated but whose investment manager is appropriately regulated provided that the investment manager of such broad based fund is itself registered as Category II foreign portfolio investor;

   (iv) university funds and pension funds; and

   (v) university related endowments already registered with SEBI as foreign institutional investors or sub-accounts.
For the purposes of this clause, an applicant seeking registration as a foreign portfolio investor shall be considered to be “appropriately regulated”, if it is regulated or supervised by the securities market regulator or the banking regulator of the concerned foreign jurisdiction, in the same capacity in which it proposes to make investments in India. "Broad based fund" shall mean a fund, established or incorporated outside India, which has at least twenty investors, with no investor holding more than forty-nine per cent of the shares or units of the fund. If the broad based fund has an institutional investor who holds more than forty nine per cent of the shares or units in the fund, then such institutional investor must itself be a broad based fund.

(c) "Category III foreign portfolio investor" which shall include all others not eligible under Category I and II foreign portfolio investors such as endowments, charitable societies, charitable trusts, foundations, corporate bodies, trusts, individuals and family offices.

Registration of FPI

No person shall buy, sell or otherwise deal in securities as a foreign portfolio investor unless it has obtained a registration certificate granted by the designated depository participant (DDP) on behalf of SEBI. Registration is to be granted within 30 days of application, subject to requisite information being provided, and will be permanent unless suspended or cancelled.

Registration Fees

FPIs belonging to Category I are exempted from the payment of registration fees. FPIs belonging to Category II and III have to pay registration fees of USD 3000 and USD 300, respectively or any other amount specified by SEBI from time to time, for every block of three years, till the validity of its registration.
Conversion of existing FIIs/sub-accounts and QFIs

All the FIIs/sub-accounts may continue to buy, sell or otherwise deal in securities under the FPI regime until the expiry of their existing registration, or until they register as a FPI. QFIs may continue to buy, sell or otherwise deal in securities until a period of one year from the date of notification of these regulations. In the meantime, they may obtain FPI registration through DDPs.

A foreign institutional investor or sub-account who has been granted registration by SEBI prior to the commencement of these regulations are required to pay conversion fees of USD 1000 to SEBI on or before the expiry of its registration as a foreign institutional investor or subaccount, by way of electronic transfer in the designated bank account of SEBI, in order to buy, sell or otherwise deal in securities under the SEBI (Foreign Portfolio Investors) Regulations, 2014.

However, an applicant, which is an international/multilateral agency such as World Bank and other institutions, established outside India for providing aid, which have been granted privileges and immunities from payment of tax and duties by the Central Government, is exempt from paying any fee.

Investment Restrictions

(1) A foreign portfolio investor is permitted to invest only in the following securities, namely-

(a) Securities in the primary and secondary markets including shares, debentures and warrants of companies, listed or to be listed on a recognized stock exchange in India;
(b) Units of schemes floated by domestic mutual funds, whether listed on a recognized stock exchange or not;
(c) Units of schemes floated by a collective investment scheme;
(d) Derivatives traded on a recognized stock exchange;
(e) Treasury bills and dated government securities;
(f) Commercial papers issued by an Indian company;
(g) Rupee denominated credit enhanced bonds;
(h) Security receipts issued by asset reconstruction companies;
(i) Perpetual debt instruments and debt capital instruments, as specified by the Reserve Bank of India from time to time;
(j) Listed and unlisted non-convertible debentures/bonds issued by an Indian company in the infrastructure sector, where ‘infrastructure’ is defined in terms of the extant External Commercial Borrowings (ECB) guidelines;
(k) Non-convertible debentures or bonds issued by Non-Banking Financial Companies categorized as ‘Infrastructure Finance Companies’ (IFCs) by the Reserve Bank of India;
(l) Rupee denominated bonds or units issued by infrastructure debt funds;
(m) Indian depository receipts, and
(n) Such other instruments specified by SEBI from time to time.

(2) If a foreign institutional investor or a sub account, prior to commencement of these regulations, holds equity shares in a company whose shares are not listed on any recognized stock exchange, and continues to hold such shares after initial public offering and listing thereof, such shares are subject to lock-in for the same period, if any, as is applicable to shares held by a foreign direct investor placed in similar position, under the policy of the Government of India relating to foreign direct investment for the time being in force.

(3) A foreign portfolio investor is allowed to transact in the securities in India only on the basis of taking and giving delivery of securities purchased or sold, except -
   i. any transactions in derivatives on a recognized stock exchange,
ii. short selling transactions in accordance with the framework specified by SEBI, and

iii. any transaction in securities pursuant to an agreement entered into with the merchant banker in the process of market making or subscribing to unsubscribed portion of the issue in accordance with Chapter XB of the Securities and Exchange Board of India (Issue of Capital and Disclosure Requirements) Regulations, 2009.

(4) No transaction on the stock exchange can be carried forward.

(5) The transaction of business in securities by a foreign portfolio investor can be only through stock brokers registered by SEBI.

(6) A foreign portfolio investor can hold, deliver or cause to be delivered securities only in dematerialized form.

(7) In respect of investments in the debt securities, the foreign portfolio investors have to comply with terms, conditions or directions, specified or issued by SEBI or Reserve Bank of India, from time to time, in addition to other conditions specified in SEBI (Foreign Portfolio Investors) Regulations, 2014.

(8) The purchase of equity shares of each company by a single foreign portfolio investor or an investor group is limited by a ceiling of ten percent of the total issued capital of the company.

**Offshore Derivative Instruments (ODIs)**

"Offshore derivative instrument" means any instrument, by whatever name called, which is issued overseas by a foreign portfolio investor against securities held by it that are listed or proposed to be listed on any recognised stock exchange in India, as its underlying.

Following are the conditions for issuance of offshore derivative instruments:
(1) FPIs may issue, subscribe to or otherwise deal in offshore derivative instruments, directly or indirectly only if the following conditions are satisfied:

(a) such offshore derivative instruments are issued only to persons who are regulated by an appropriate foreign regulatory authority;

(b) such offshore derivative instruments are issued after compliance with ‘know your client’ norms.

Unregulated broad based funds, which are classified as Category II foreign portfolio investor by virtue of their investment manager being appropriately regulated, and also Category III foreign portfolio investors, are not allowed to issue, subscribe or otherwise deal in offshore derivatives instruments directly or indirectly.

(2) A foreign portfolio investor must ensure that further issue or transfer of any offshore derivative instruments issued by or on behalf of it is made only to persons who are regulated by an appropriate foreign regulatory authority.

(3) Foreign portfolio investors are required to fully disclose to SEBI any information concerning the terms of and parties to off-shore derivative instruments such as participatory notes, equity linked notes or any other such instruments, by whatever names they are called, entered into by it relating to any securities listed or proposed to be listed on any stock exchange in India.

(4) Any offshore derivative instruments issued under the Securities and Exchange Board of India (Foreign Institutional Investors) Regulations, 1995 before commencement of these regulations shall be deemed to have been issued under the corresponding provision of these regulations.

Designated Depository Participants (DDPs) and Custodian of Securities

Existing qualified depository participants and custodians of securities registered/ approved by SEBI before commencement of FPI Regulations shall be deemed to have been granted
registration as DDPs under the FPI Regulations, subject to payment of the specified fees. FPIs have to mandatorily appoint a custodian of securities before making any investments. The custodian shall ensure that combined holdings of all FPIs in the same investor group remains below ten per cent of the issued capital of the investee company at any time. DDPs are required to ensure that FPIs submit an undertaking along with a certificate from a chartered accountant to an authorised dealer certifying that all taxes have been paid or funds have been set aside to meet the tax liability before remittance of any sum out of India.

4.4 Summary

The SEBI (Foreign Portfolio Investors) Regulations, 2014, by substantial easing of the entry norms, rationalizing and simplifying foreign portfolio investment norms in India, is expected to boost FPI in Indian capital markets. Granting of permanent registrations to FPIs help them avoid repeated approach to the designated depository participants (DDPs), and provide them a more supportive environment for investment in India. With the delegation of work to DDPs, SEBI can now focus on more important issues and perform its regulatory role more effectively. As a buffer period has been given to operate, without the requirement of immediate compliance with the formalities and the process for conversion to and operation as FPIs, the transition to the new regime has been a comfortable one to all classes of investors that have been merged. The surge in FPI inflows, immediately after the introduction of SEBI (Foreign Portfolio Investors) Regulations, 2014, reflects reinforced sentiments of Foreign Portfolio Investors and justifies the suitability and effective timeliness of introduction of the Regulations.

In this scenario, the influence of FPI holdings on the dynamics of Indian stock markets assumes immense importance and hence is analysed in depth in next Chapter V.