Note

New Opportunities & Better Investments for QFIs: Scope widened to include Investments in Indian Corporate Debt Securities

Paridhi Bagaria
bagaria.paridhi@gmail.com

Rozy Jain
rozy@vinodkothari.com
July 25, 2012

Vinod Kothari & Company

Check at:
http://india-financing.com/staff-publications.html
for more write ups.

Note

The Indian Government with a view to open up more lucrative investment avenues for foreign investors and in line with its liberal approach towards foreign investments, has come up with the decision of allowing ***Qualified Foreign Investors*** ("**QFIs**") to invest in ***Indian Corporate Debt Securities*** and ***Debt Schemes of Indian Mutual Funds.***

Backdrop

QFIs entered the Indian Capital market through **RBI's Circular No. RBI/2011-12/347 A. P. (DIR Series) Circular No.66** dated **January 13, 2012**[1] which notified that QFIs are allowed to invest in rupee denominated units of domestic Mutual Funds. Following a liberal-cum-conservative approach, QFIs were initially allowed to invest in schemes of Indian mutual funds and Indian equity shares by opening a demat account with a Qualified Depository Participant ("**DP**") within the overall limits given below:

a. Total individual shareholding not to exceed 5% of the paid-up capital of the company at any point of time.

b. Total aggregate shareholding not to exceed 10% of the paid-up capital of the company at any point of time.

The limits shall be over and above the Foreign Institutional Investors ("**FII**") and Non Resident Indian investment ceilings prescribed under the Portfolio Investment Scheme for foreign investment in India, but within the overall Foreign Direct Investment ("**FDI**") sectoral caps under the existing FDI policy.

Thereafter, pursuant to the announcement made in Budget 2012-13, the Ministry of Finance ("**Ministry**"), decided ***to permit QFIs to invest in corporate bonds in India[2], simultaneously relaxing the earlier norms vide.***

Presently, only international High Net worth Individuals ("**HNIs**") with a minimum net worth of US$50 million and registered as a sub-account of the FIIs are permitted to directly participate in the stock market. Now, RBI and SEBI, after consultation with the Government of India ("**GOI**"), have come out with Circulars issued by the Reserve Bank of India ("**RBI**") and the Securities and Exchange Board of India ("**SEBI**")[3] permitting QFIs to invest in Indian corporate debt.

QFIs: scope re-defined

As per the earlier definition, QFIs were persons non-resident in India but resident in a country that is compliant with Financial Action Task Force ("**FATF**") standards and that is a signatory to the Multilateral Memorandum of Understanding ("**MMOU**") of the International Organization of Securities Commission ("**IOSCO**"). But the definition has been slightly changed now.

---

[1] The Circular is available at http://rbi.org.in/scripts/NotificationUser.aspx?Id=6937&Mode=0. *Also see*, our Note on Direct access to QFIs in Indian Equity Market

[2] See Press Release by Ministry of Finance: http://finmin.nic.in/press_room/2012/Rational_QFI_Scheme.pdf

[3]The Circular is available at http://www.sebi.gov.in/cms/sebi_data/attachdocs/1342784172262.pdf

Note

RBI in its latest Circular RBI/2012-13/134 A. P. (DIR Series) Circular No. 7 dated 16th July 2012[4] has defined QFI as follows:

QFI means a person who is resident in a country that is:

a. a member of FATF, or
b. a member of a group which is a member of FATF (not being an associate member); and
c. a signatory to IOSCO's MMoU (Appendix A Signatories therein), or
d. a signatory of a bilateral Memorandum of Understanding with SEBI.

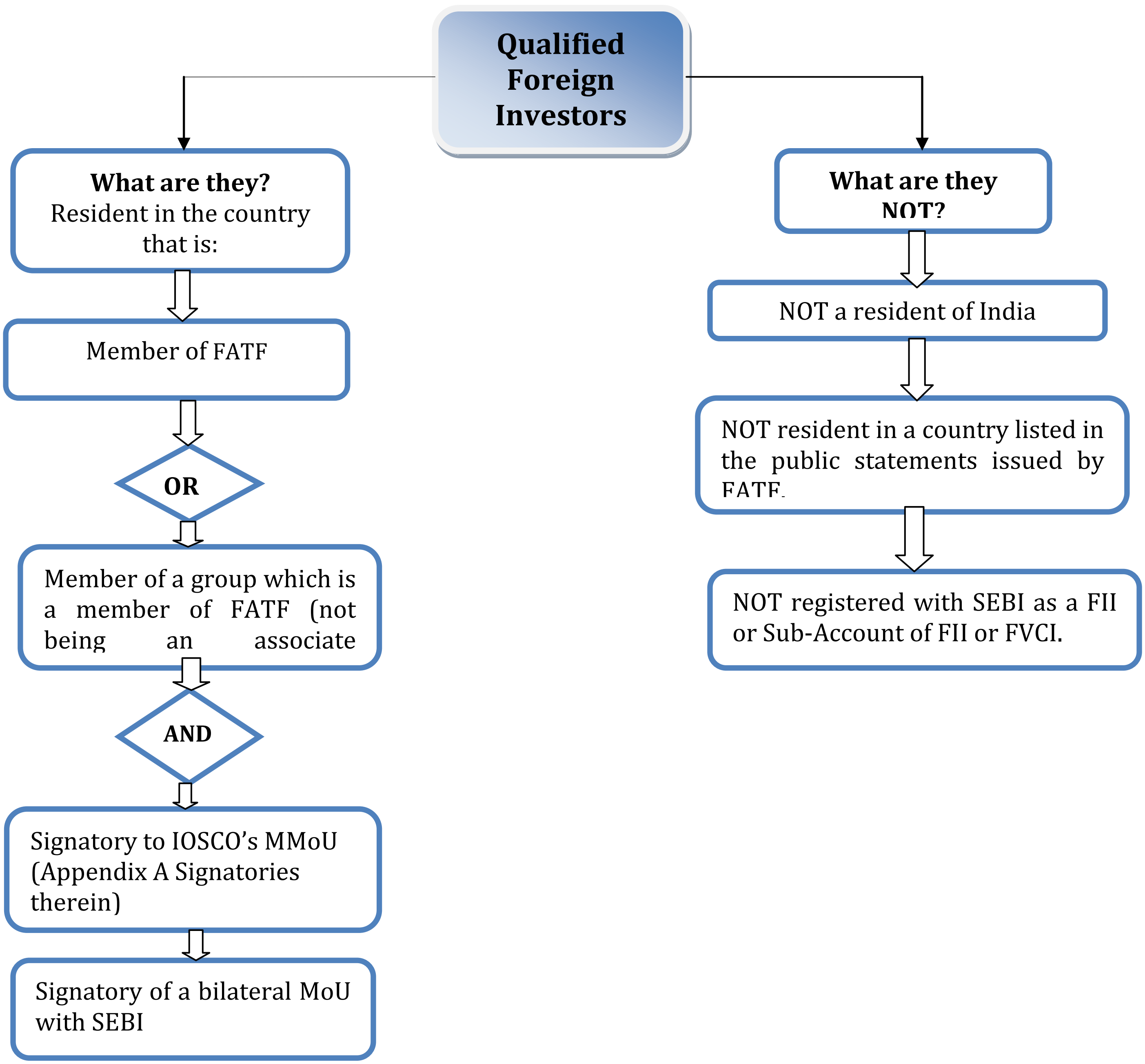
However, the person should not be resident in a country listed in the public statements issued by FATF from time to time on jurisdictions having a strategic Anti-Money Laundering/Combating the Financing of Terrorism ("AML/CFT") deficiencies to which counter measures apply or that have not made sufficient progress in addressing the deficiencies or have not committed to an action plan developed with the FATF to address the deficiencies.

Essentially, the QFI **should not be resident in India** and **not registered with SEBI as a FII or Sub-account of FII or Foreign Venture Capital Investor** ("**FVCI**").

[4] The Circular is available at http://www.rbi.org.in/scripts/NotificationUser.aspx?Id=7456&Mode=0

Note

The illustration given in Figure: 1 clarifies the basic concept of QFIs:



<u>Figure 1: Qualified Foreign Investors</u>

Note

QFIs permitted to purchase debt securities

It has been decided to allow QFIs to purchase on repatriation basis debt securities subject to the following terms and conditions:

a. Eligible instruments and eligible transactions

Broad Guidelines have been prescribed in this regard:

i. *Eligible instruments:*

A. Permission to invest through SEBI registered Qualified Depository Participants (QDPs) in eligible corporate debt instruments-
B. listed Non-Convertible Debentures(“**NCDs**”),
C. listed bonds of Indian companies,
D. listed units of Mutual Fund debt Schemes and
E. “to be listed” corporate bonds .

ii. *Transaction to be carried out through:*

A. An Issuer; or
B. A Registered stock broker on a Recognised stock exchange of India.

QFIs shall also be permitted to sell ‘eligible debt securities’ so acquired by way of sale through registered stock broker on a recognized stock exchange in India or by way of buyback or redemption by the issuer.

As per the SEBI Circular, the transactions will remain restricted to:

i. Purchase and sale of corporate debt securities listed on ***recognized stock exchange(s);***
ii. Purchase of corporate debt securities through ***public issues***, if the listing on recognized stock exchange(s) is committed to be done as per the extant provisions of the Companies Act, 1956;
iii. Sale of corporate debt securities by way of ***buyback or redemption*** by the issuer;
iv. Purchase and sale of units of ***debt schemes of Indian mutual funds.***

The provisions relating to FIIs in case of non-listing of “to be listed” corporate bonds within 15 days as per SEBI Circular CIR/IMD/FIIC/18 /2010 dated November 26, 2010[5], shall be applicable to QFIs.

*Therefore, QFIs are now permitted to invest in these securities (hereinafter referred to as “**eligible securities**”):*

[5] The Circular is available at http://www.sebi.gov.in/circulars/2010/cirimdfiic182010.pdf

Note

i. Units of domestic mutual funds.
ii. Equity shares of listed Indian companies.
iii. Eligible debt securities, as enumerated above.

b. Mode of payment / repatriation

QFI are allowed to open single non bearing interest rupee account with an AD Category I bank in India for routing the receipts and payments for transactions relating to eligible securities for QFIs, provided:

i. Inward remittance to take place only through normal banking channel and by credit of the sale/redemption/buyback proceeds (net of taxes) and on account of interest payment / dividend on the eligible securities for QFIs.
ii. The funds in this account shall be utilized for purchase of eligible securities for QFIs or for remittance (net of taxes) outside India.
iii. The DP will operate such account at the instructions of the QFIs.

Therefore, the requirement of maintaining a single rupee pool bank account has been dispensed with.

c. Demat account

For all investments in 'eligible securities for QFIs' in India, QFIs need to open a single demat account with a QDP; multiple accounts not required.

d. Limits on investment in Corporate Debt securities and Mutual Fund debt Schemes

A total overall ceiling of USD 1 billion has been prescribed. The securities are required to be without any lock-in or residual maturity clause. However, the good news for QFIs is: the limit is over and above USD 20 ***billion for FII investment in corporate debt.***

e. Know Your Customer (KYC)

QDPs And AD Category-I banks are under an obligation to observe KYC norms as applicable.

f. Permissible currencies

QFIs will remit foreign inward remittance through normal banking channel in any permitted currency (freely convertible) directly into single non-interest bearing Rupee account of the DP maintained with AD Category-I bank.

g. Hedging

QFIs would be permitted to hedge their currency risk on account of their permissible investments (in equity and debt instruments) in terms of the guidelines issued by the RBI from time to time.

Points to be additionally noted

One has to take a note of the following facts:

Aggregate Investments without prior approval	Upto 90% of USD 1 billion i.e. USD 0.9 billion.
Allocation of investment limits	Individual and aggregate investment limits for the QFIs shall be 5% and 10% respectively of the paid up capital of an Indian company.
Monitoring	a. In terms of SEBI circular dated January 13, 2012. b. Depositories to ensure that the aggregate limits are not breached.
Publication/dissemination of aggregate investments	By the depositories to public, on daily basis.
On reaching the limits	Notice in this regard to be published by the depositories on their websites.
For fresh purchases after limits are crossed	a. Prior approval of depositories required. b. Depositories to inform recognize stock exchange and DPs nation wise for every fresh issue. c. Approval may be given on first-come-first-served basis in co-ordination with the other depository. d. Validity of the approval shall be for the next trading day only. e. The depositories to jointly notify the respective DPs regarding the breach along with the names of the QFI due to

Note

	whom the limits have been breached. f. QFI due to whom the limit is breached are mandatorily required to divest excess holdings within 3 working days of such breach being notified by depositories to the DP.

Conclusion

The new scheme has led to opening up of another avenue for global investors through which they can participate in the Indian corporate debt markets and debt schemes of Indian Mutual Funds. This would increase the global investor interest in the Indian economy. The QFI scheme will make it easier for overseas investors to participate in the priority sector projects in India, and therefore would provide an additional source of overseas long term debt funding.

"It's a welcome step but we need to wait and watch how many QFIs are willing to take exposure in mutual fund debt market as currency risk and tax issues are two major factors that makes these funds unattractive for QFIs," ***as quoted by Vijai Mantri, MD and CEO Pramercia AMC.***

"The QFIs already have good performing dollar denominated funds in their respective countries so such relaxation in norms will not have a major impact in inflows," ***as quoted by Akshay Gupta, MD and CEO Peerless Mutual Fund.***[6]

Hence, to sum up, it can be rightly said that Foreign Capital inflows to India have significantly grown in importance over the years. These flows have been influenced by strong domestic fundamentals and buoyant yields reflecting robust corporate sector performance.

An interesting move in terms of including the corporate bonds as part of eligible instruments is the fact that in the current regime of harder interest rates more foreign investors are interested at investing in Indian corporate debt which will go a long way in creating interest amongst foreign investors in the immediate run. The new step seeks to widen the class of investors in India, deepen the financial market, attract more foreign funds and reduce market volatility. Though the investment opportunity is attractive enough, yet the regulator has set strict norms so as to avoid any kind of lacuna in the system.

[6] *See* http://www.cafemutual.com/News/InnerNews.aspx?srno=1833&MainType=New&NewsType=Industry&id=