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UPDATE ON
INBOUND AND OUTBOUND TRANSACTIONS
30 March 2012 : Andheri Study Circle

**BY CA.SUDHA G. BHUSHAN**

INSTITUTE OF COMPANY SECRETARIES OF INDIA

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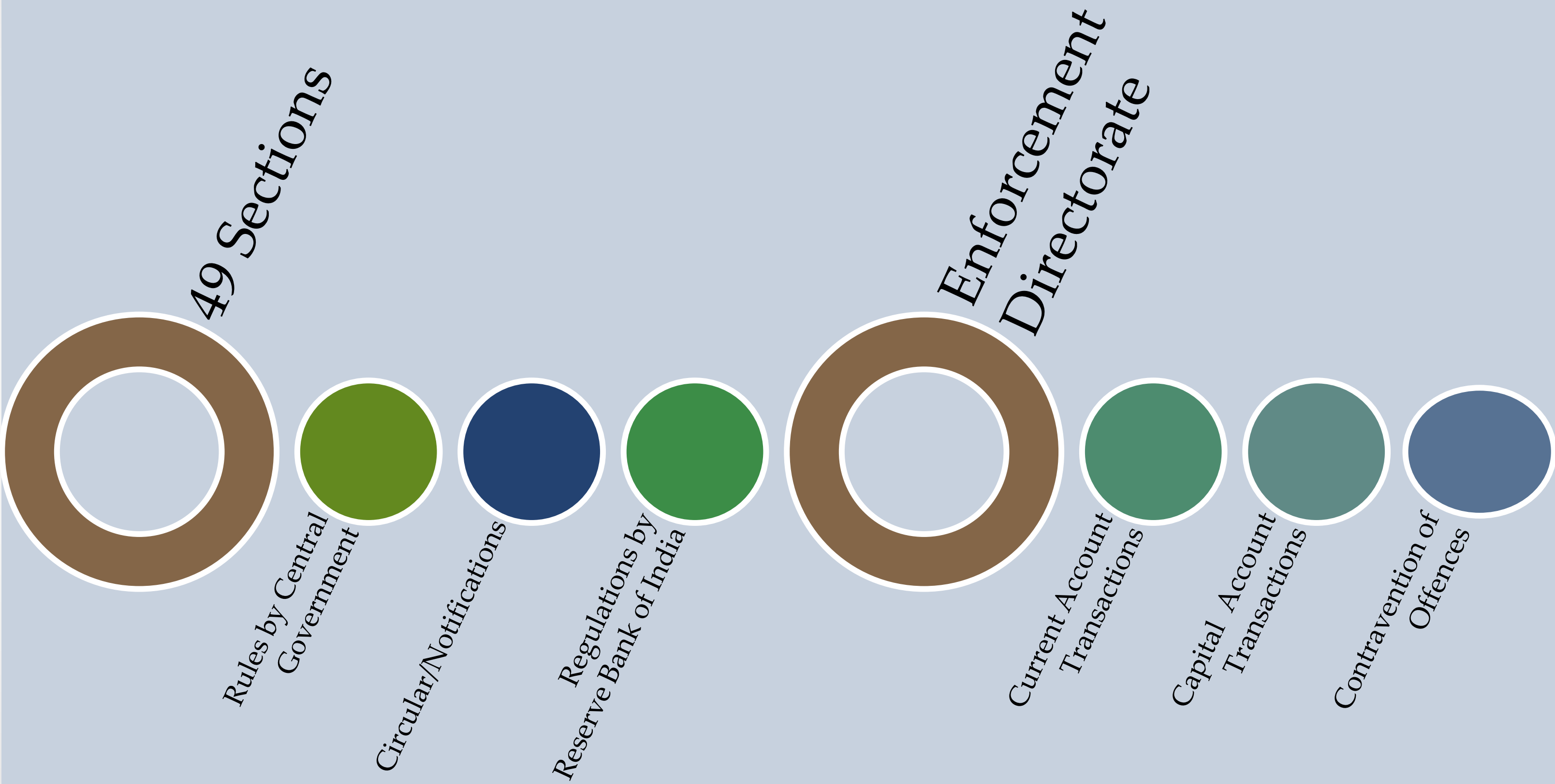

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# Inbound Transactions

By CA. Sudha G. Bhushan

Modes of Foreign Investment

- Foreign Direct Investments (FDI) into Indian Company
- SEBI registered Foreign Institutional Investors (FII)
- SEBI approved Foreign Venture Capital Fund (FVCF)

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| | |
|---|---|
| FDI | • Suitable entry mode for strategic and management control |
| FII | • Suitable entry mode for portfolio / capital investments and secondary market operations |
| FVCI | • Suitable entry mode for project specific investment in unlisted companies / VCF |

| Category of Investors | Typical Investment Option |
|---|---|
| Strategic Investment | Foreign Direct Investment [FDI] |
| Private Equity | FDI/ FVCF/FII |
| Financial Investment | FII/FVCF |
| Institutional Investment | FII |
| | |

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# Inbound transactions

- Clause (b) sub-section (3) of Section 6 of the Foreign Exchange Management Act, 1999
- FEMA 20 - F**oreign Exchange Management (Transfer or issue of security by a person resident outside India) Regulations, 2000 [ the Notification]**
- Schedule 1 of the notification :- FDI
- Schedule 2 of the notification:- FII
- Schedule 6 of the notification :- FVCI

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# Foreign Institution Investors


By CA. Sudha G. Bhushan

# Key legal / regulatory matrix for FII and FVCI

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## FII / FVCI

### SEBI

- SEBI Act, 1992
- FII - SEBI (FII) Regulations, 1995
- FVCI - SEBI (FVCI) Regulations, 2000
- SEBI (Custodial of Securities) Regulations, 1996
- SEBI (ICDR) Regulations, 2009
- Securities Contracts (Regulation) Act, 1956

### FEMA

- FEMA (Transfer or Issue of Security by a Person Resident Outside India) Regulations, 2000 (FEMA 20)
- Master Circular on Foreign Investments in India
- Circulars/ press releases issued from time to time

### FDI Policy

- Consolidated FDI Policy (Issued half yearly)
- Press Notes

### Income Tax

- The Income-tax Act,1961
- Double Taxation Avoidance Agreements, as may be applicable

# FIIs - General framework

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- **FIIs**

  - An eligible institution set- up or incorporated outside India which invests in Indian listed shares / securities post registration with SEBI as per prescribed guidelines / framework

- **Approval**

  – SEBI (single window clearance) and concurrence of Reserve Bank of India (RBI) in case the applicant is a Bank or its subsidiary

- **FIIs registered with SEBI as:**

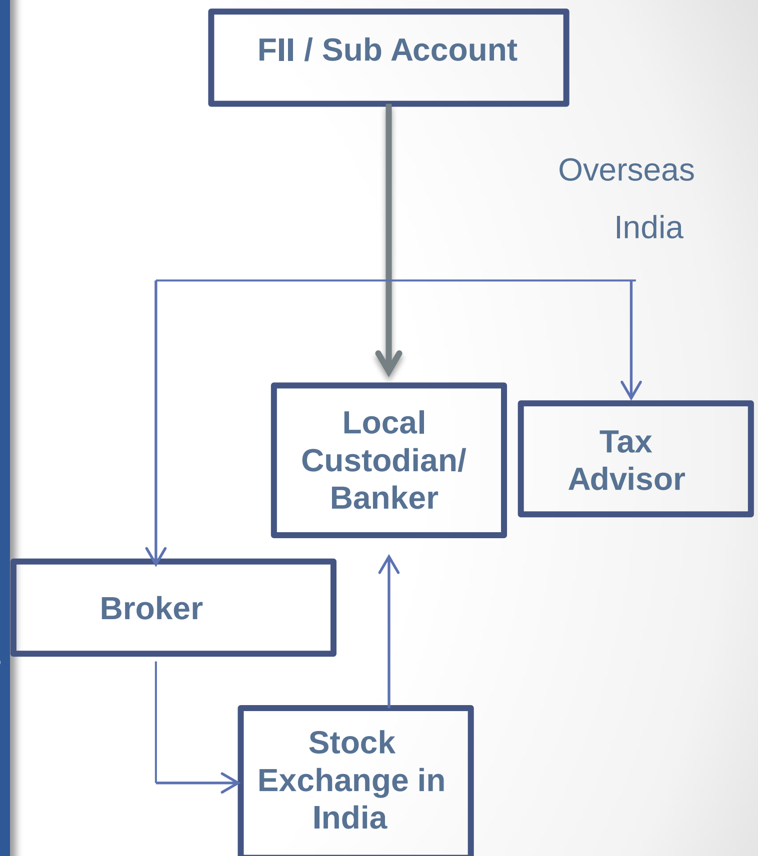
  - **Investor**: For self investment in Indian shares / securities

  - **Manager:** Investment is done on behalf of their eligible clients ( Clients registered as Sub-accounts of FIIs with SEBI)

- **Bank Accounts permitted in India**

  - Non-interest bearing foreign currency account; and / or

  - Single non-interest bearing special non-resident rupee account (SNRR)



# FIIs - Consideration of Application by SEBI

- Track record, professional competence, financial soundness, experience, and general reputation of fairness and integrity
- For Newly established funds - the track record of the investment manager (who are promoters) considered
- Details of Foreign Regulatory Authority governing the FII
- Fit and Proper criteria
- Interest of development of securities market

Form A as prescribed in SEBI (FII) Regulations, 1995 → Certified copy of Memorandum of Association, Article of Association or Article of Incorporation. → Audited financial statement and annual report for the last one year → Demand draft of US $ 5,000 in favour of SEBI

**In case of University fund, Endowment, Foundation, Charitable trusts or Charitable society;**

- It exists at least for 5 years
- It is permitted to invest in securities outside the country of its incorporation or establishment
- It is registered with any statutory authority in the country of their incorporation or establishment
- Details of any legal proceeding initiated by any statutory authority against the Applicant
- Serving of Public Interest by the Applicant

# Procedure of Registration of FII

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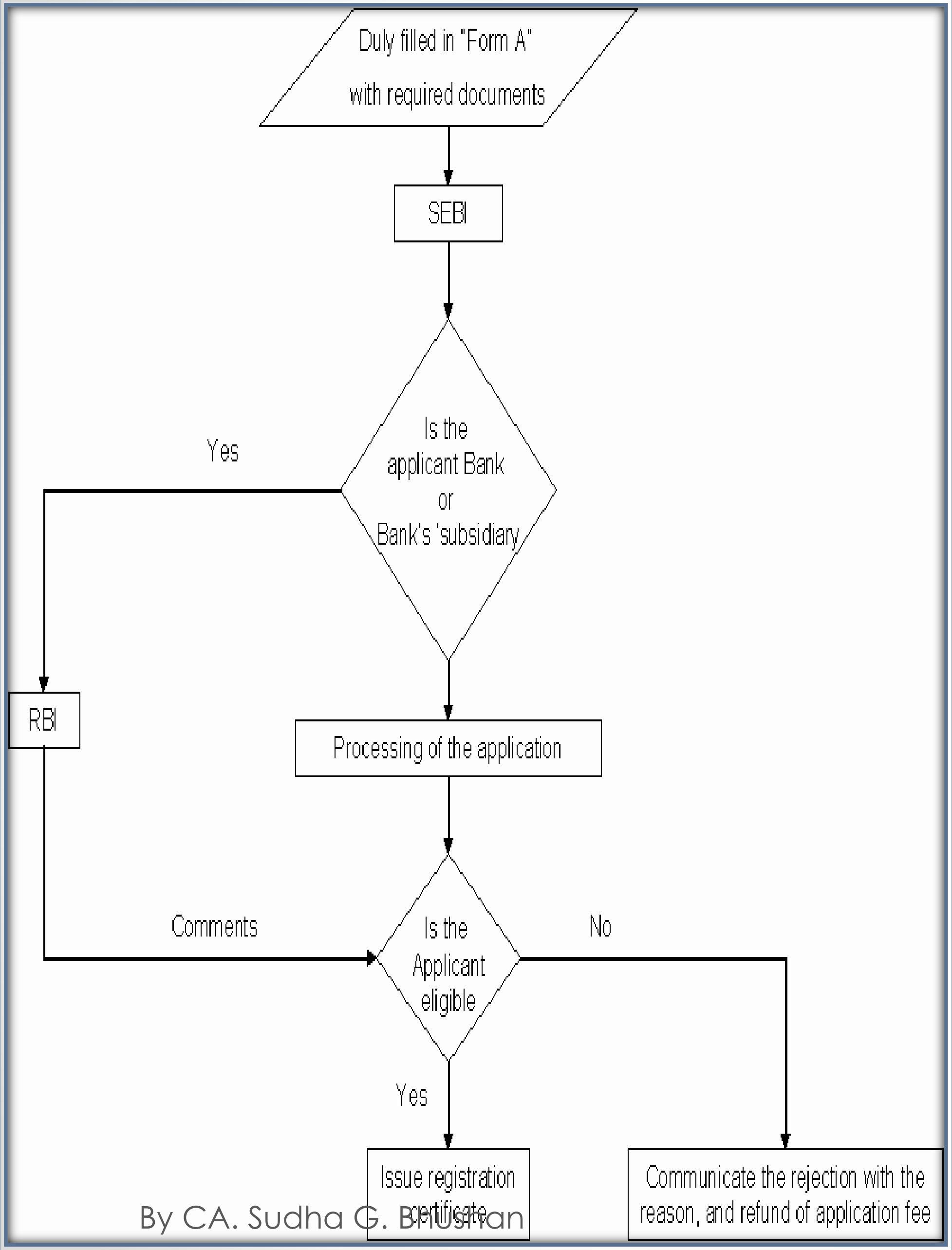


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Following entities / funds are eligible to get registered as FII:

- Pension Funds
- Mutual Funds
- Insurance Companies
- Investment Trusts
- Banks
- University Funds
- Endowments
- Foundations
- Charitable Trusts / Charitable Societies

Further, following entities proposing to invest on behalf of broad based funds, are also eligible to be registered as FIIs:

- Asset Management Companies
- Institutional Portfolio Managers
- Trustees
- Power of Attorney Holders

# FIIs - Investment in shares / convertible debentures on Recognized Stock Exchange through Registered Broker

- Investment ceiling for each FII / their each Sub-account (to be monitored by Custodian)
  - Up to 10% of the total issued / paid-up capital (or each series of convertible debentures) of an Indian company
  - If sub-account registered under Foreign Corporate / Individuals category, then it can invest up to 5% of the total paid-up capital (or each series of convertible debentures) of an Indian company
- Overall FII Investment Limits for all FIIs and their Sub-accounts (monitored by RBI)
  - Up to 24% of the total paid-up capital (or each series of convertible debentures) of an Indian company (20% in the case of public sector banks as per FDI policy)

The above ceiling can be raised by the Indian Investee Company up to the sectoral limit under FDI guidelines if a resolution is passed by its **Board of Directors followed by a special resolution in its General Body Meeting**

FIIs not allowed to invest in an Indian company engaged in Chit Fund / Nidhi Company / Agriculture and Plantation Activity or Real Estate Business (except as defined - construction, housing, etc), Construction of Farm Houses, Trading in TDRs and Asset Reconstruction Business (ARCs)

# Investment Framework - Eligible Securities

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**Purchase of Other securities by FIIs**

- INR Denominated IDRs issued by Foreign Companies in the Indian Capital Market in accordance with FEMA / Indian regulations
- Dated Government Securities / Treasury Bills
- Listed NCDs / Bonds
- Commercial papers issued by Indian Companies
- Units of Domestic Mutual Funds
- Security Receipts issued by ARCs
- Interest Rate Futures
- Perpetual debt instruments (eligible for inclusion as Tier I capital and debt capital instruments (eligible for inclusion as upper Tier II capital) issued by banks in India

**Purchase of Debt Instruments / Dated Government Securities by FIIs - Overall ceiling**

| | (USD Bn) |
|---|---|
| Govt. securities/ T-Bills | 10.00 (Note 1) |
| Corporate Debt | 40.00 (Note 2) |
| **Total** | **50.00** |

Note 1 - The overall limit has been increased from existing USD 5 billion to USD 10 billion. The incremental USD 5 billion to be invested in securities with residual maturity of over 5 years

Note 2 -The overall limit has been increased from existing USD 15 billion to USD 40 billion. The incremental USD 25 billion to be invested in Corporate bonds with residual maturity of over 5 years issued by companies in infrastructure sector.

For Security Receipts of ARC, Corporate / Perpetual Debt Instruments and Dated Government Securities, 10% individual FII and 49% aggregate FIIs ceiling applicable to each series / issue

# FIIs - Other points



**Off-shore Derivative Instruments (ODIs)**

- FII can issue ODIs against underlying listed (or proposed to be listed)Indian securities
- ODIs can be issued only to persons regulated by appropriate foreign regulatory authority after compliance with KYC norms such as
  - person regulated/supervised and licensed/registered by a foreign central bank
  - person registered and regulated by a securities or futures regulator in any foreign country or state
  - broad-based fund or portfolio incorporated or established outside India or proprietary fund of a registered FII/ university fund, endowment, foundation, charitable trust or charitable society whose investments are managed by eligible persons



**Other key benefits / features for FIIs**

- FIIs are allowed to hedge foreign currency risks subject to prescribed terms and conditions
- FIIs are permitted to cancel and rebook foreign exchange forward contracts upto 10 percent of the market value of the portfolio as at the beginning of the financial year
- FIIs are allowed to hedge risk against default in corporate bonds as per the Credit Default Swaps (‘CDS’’) guidelines issued by RBI; FIIs can buy CDS contracts
- FIIs are required to file prescribed details with the Competition Commission of India (‘CCI’) if their investments in an Indian Company are pursuant to an investment agreement or loan agreement

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# NET Investments - 2011 (in INR crore)

| | Equity | Debt | Total |
|---|---|---|---|
| January | -4,813.2 | 10,176.7 | 5,363.5 |
| February | -4,585.5 | 1,315.7 | -3,269.8 |
| March | 6,897.8 | -14.9 | 6,882.9 |
| April | 7,213.3 | 17.2 | 7,196.1 |
| May | -6,614.4 | 2,338.4 | -4,276.0 |
| June | 4,572.2 | 311.1 | 4,883.3 |
| July | 8,030.1 | 2,622.8 | 10,652.9 |
| August | -10,833.6 | 2,931.1 | -7,902.5 |
| September | -158.3 | -1,707.4 | -1,865.7 |
| October | 1,677.4 | 1401.4 | 3078.8 |
| November | -4,197.9 | 934.7 | -3,263.2 |
| December | | | |
| Total FII Investment | -2812.1 | 20292.4 | 17480.3 |

* The data presented above is compiled on the basis of reports submitted to SEBI by custodians and constitutes trades conducted by FIIs on and upto the previous trading day(s).

* No bifurcation of net investment data available before March 1997

| Reporting Date | Debt/Equity | Investment Route | Gross Purchases (Rs Crore) | Gross SaleS (Rs Crore) | Net Investment (Rs Crore) | Net Investment US($) million | Conversion (1 USD TO INR)* |
|---|---|---|---|---|---|---|---|
| 30-MAR-2012 | Equity | Stock Exchange | 3948.20 | 5237.70 | (1289.50) | (252.12) | Rs.51.145 |
| | | Primary market & others | 0.00 | 9.90 | (9.90) | (1.94) | |
| | | Sub-total | 3948.20 | 5247.60 | (1299.40) | (254.07) | |
| | Debt | Stock Exchange | 518.50 | 1893.30 | (1374.90) | (268.81) | |
| | | Primary market & others | 286.00 | 0.00 | 286.00 | 55.91 | |
| | | Sub-total | 804.40 | 1893.30 | (1088.90) | (212.90) | |
| | | Total | 4752.60 | 7140.90 | -2388.30 | -466.97 | |

The data presented above is compiled on the basis of reports submitted to SEBI by custodians on 30-MAR-2012 and constitutes trades conducted by FIIs on and upto the previous trading day(s).

Souce : [WWW.sebi.gov.in](http://WWW.sebi.gov.in)

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# Recent Changes

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# Certificate from Company Secretary

**RBI/2011-12/453 A.P. (DIR Series) Circular No. 94 dated 19 March 2012**

Indian company raising the aggregate FII investment limit of 24 per cent to the sectoral cap/ statutory limit or the aggregate NRI investment limit of 10 per cent to 24 per cent

→

Certificate from the Company Secretary stating that all the relevant provisions of the extant Foreign Exchange Management Act, 1999 regulations and the Foreign Direct Policy, as amended from time to time, have been complied with

# To be listed debt securities

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**RBI/2011-12/423 A.P. (DIR Series) Circular No. 89**

- SEBI registered FIIs/sub-accounts of FIIs are allowed invest in primary issues of Non-Convertible Debentures (NCDs)/ bonds only if listing of such bonds / NCDs is committed to be done within 15 days of such investment.

- In case the NCDs/bonds issued to the SEBI registered FIIs / sub-accounts of FIIs are not listed within 15 days of issuance to the SEBI registered FIIs / sub-accounts of FIIs, for any reason, then the FII/sub-account of FII shall immediately dispose of these bonds/NCDs either by way of sale to a third party or to the issuer and the terms of offer to FIIs / sub-accounts should contain a clause that the issuer of such debt securities shall immediately redeem / buyback the said securities from the FIIs/sub-accounts of FIIs in such an eventuality.

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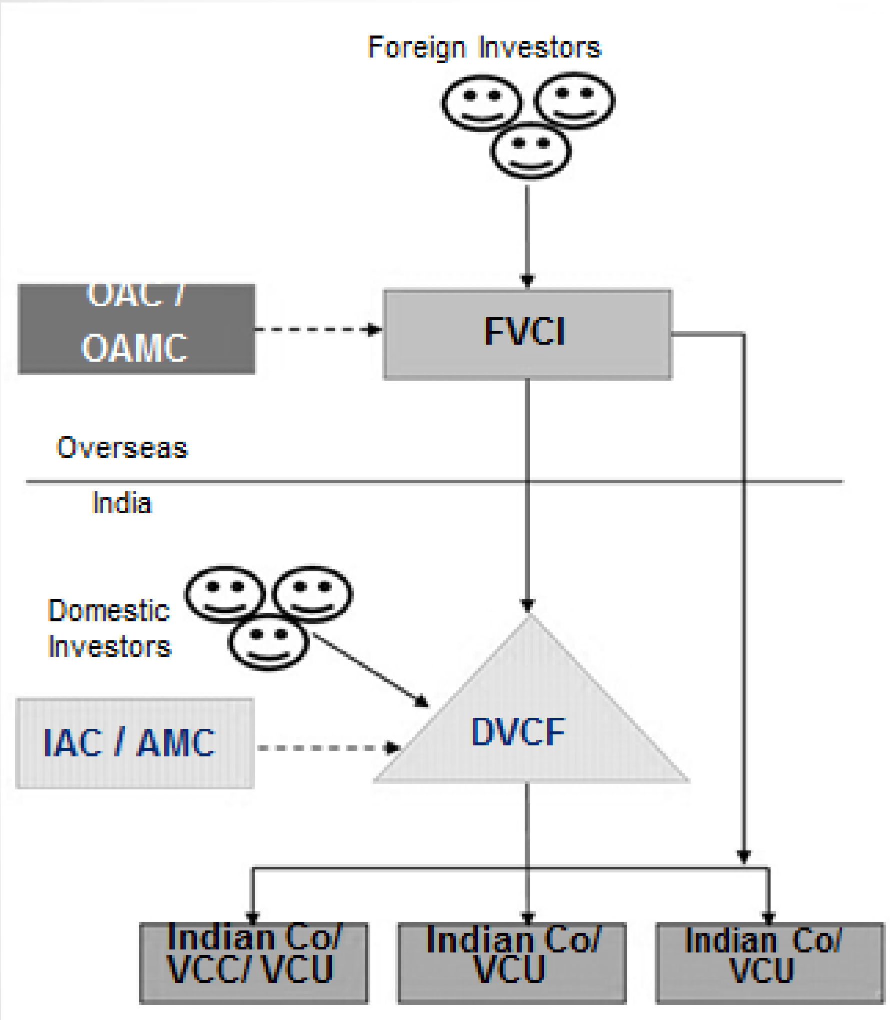
# Foreign Venture Capital Investors

By CA. Sudha G. Bhushan

# Typical FVCI Structure






- **VCF Participants**
  - FVCI - an investor incorporated or established outside India and registered with SEBI (and RBI through SEBI) under FVCI regulations for prescribed investments in India
  - DVCF - either a domestic trust or company registered with SEBI
  - VCU / Indian Unlisted Companies engaged in specified / eligible business / sectors
  - Offshore and / or Domestic Asset Management Company (AMC)
  - Offshore and / or Indian Advisory Company (IAC)
- Domestic Venture Capital Investors generally invest in VCUs through the DVCF

# FVCI - Eligibility

**Eligible entity as FVCI**

- An investment company, investment trust, investment partnership, pension fund, mutual fund, endowment fund, university fund, charitable institution or any other entity incorporated outside India.
- Asset management company, investment manager or investment management company or any other investment vehicle incorporated outside India

**Other conditions / eligibility**

- Applicant's track record, professional competence, Financial soundness, Experience, General reputation of fairness and integrity
- Whether applicant is fit and proper [as per Schedule II of SEBI (Intermediaries) Regulations, 2008]
- Whether necessary approval are granted by RBI for making investments in India, if any
- Whether applicant authorized to invest in a Venture Capital Fund (VCF) or invest as an FVCI
- Whether applicant regulated in foreign home country/ income-tax payer (if not, can submit banker's certificate of self/ promoter)
- Applicant has not been rejected by SEBI in past

# FVCI - Application Process

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- Application in **Form A** to be filed with SEBI along with applicable fees

- Key requirements to be furnished at the time of FVCI application to SEBI under Form A:
  - Brief description of the group to which applicant belongs
  - Brief description of the principal activities of the applicant
  - Details of statute under which applicant incorporated
  - Certificate of registration with home regulators
  - Copy of income-tax return filed in home country
  - Copy of banker's certificate showing fair track record of the applicant
  - Particulars of agreement entered into with domestic custodian
  - Firm commitment letter from investor for Minimum contribution
  - Furnishing copies of financial statements of the applicant and investors
  - Manner in which applicant proposes to conduct investments in India
  - Names of the client in whose behalf applicant proposes to invest in India
  - Furnishing of name, address, contact, email address of all directors and investors

Investment strategy and duration of life cycle of the fund to be disclosed to SEBI

# FVCI - Approval and General Obligations

- SEBI shall grant certificate of registration in Form B
- General obligations/ reporting
  - Any change in the information submitted at the time of filing of application, to be intimated to SEBI in writing
  - Maintenance of books of accounts, records, documents for a period of 8 years
  - FVCI to enter into an agreement with the domestic custodian to act as a custodian of securities for the FVCI
  - Online quarterly reporting by FVCI within 7 days from the end of each calendar quarter in the given format disclosing the following:
    - Sector in which the investments have been made
    - Amount of investments in each sector

# FVCI - SEBI Investment Framework

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- FVCI can invest its total funds committed in a single VCF
  - VCF defined to mean a trust/ company registered under SEBI (VCF) regulations and which raises/ invests funds in accordance with the aforesaid regulations
- Shall make Investments as under:
  - At least 66.67% of 'investible funds' in unlisted equity shares/ equity linked instruments of VCU
    - Investible funds = Committed funds for investment - Administration and fund management expenses
    - VCU means an unlisted Indian company and engaged in the business of manufacturing/ providing services and sectors except those in Negative list activities/ sectors (like NBFC, gold-financing )
  - Not more than 33.33% of investible funds may be invested by way of:
    - Subscription to Initial Public Offer of a VCU
    - Debt or debt instrument of VCU in which the FVCI has made investments
    - Preferential allotment of equity shares of listed company; subject to lock-in period of 1 year
    - Special Purpose Vehicles created for facilitating/ promoting investments
    - Equity shares / Equity linked instruments of a financially weak or sick listed company

# FVCI - FEMA Investment Framework (FEMA 20 / Schedule 6)

- Registered FVCI to invest in VCU/ VCF or scheme floated by SEBI Registered DVCF under Automatic Route
  - Sectoral caps as per FDI policy applicable
  - FEMA regulations silent on restrictions imposed on investments by FVCI in certain sectors by RBI
  - Restriction by way of letter while granting permission;
- FVCI can purchase / sale equity/ equity linked instruments/ debt/ debt instruments, debentures of a VCU/ VCF/ Schemes of VCF through IPO/ Private placement at mutually agreed prices
- RBI may permit FVCIs with in principle registration from SEBI to open non-interest bearing Foreign currency Account/ rupee account with designated branch of Authorized dealer (AD)
- AD Category I banks can offer forward cover to FVCIs to the extent of inward remittance; original cost of liquidated investments to be deducted from eligible cover

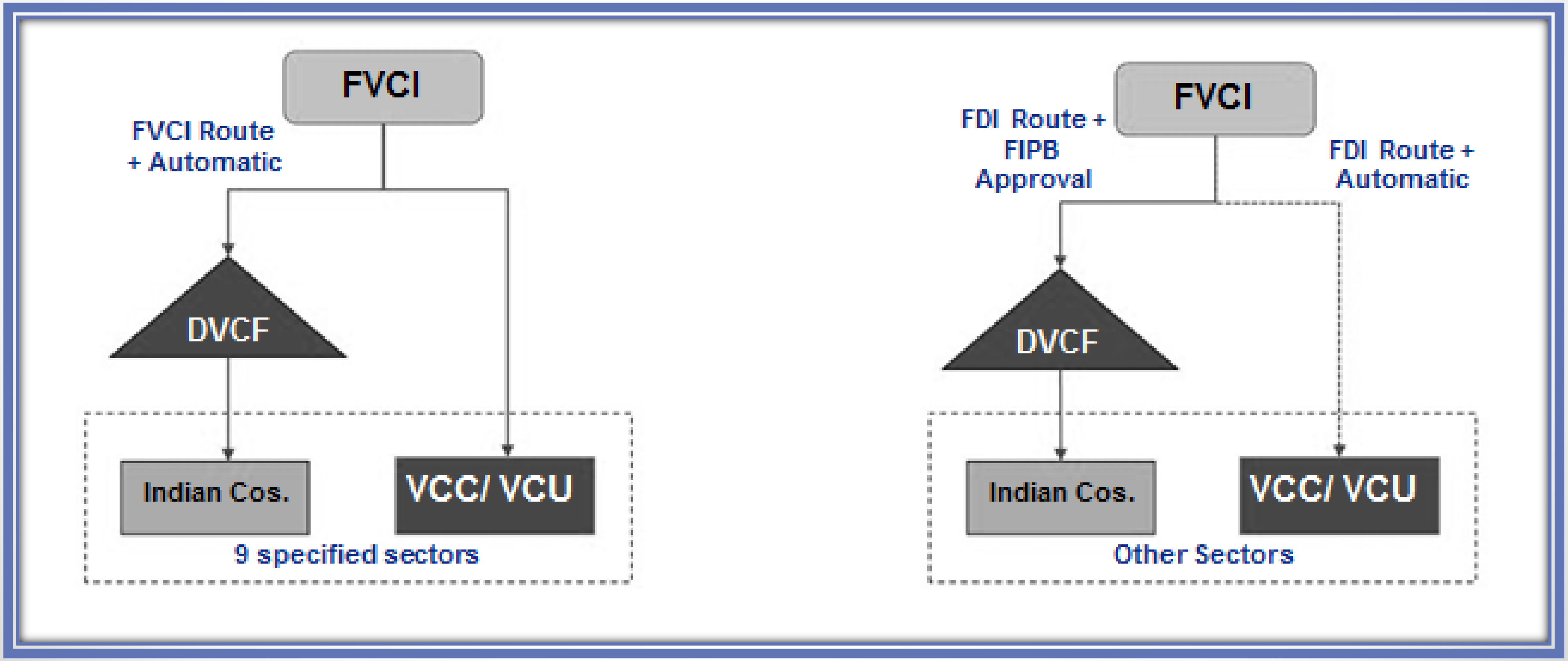
**Current FVCI registration permits investments as an FVCI in the below 9 sectors**

- Nanotechnology
- IT relating to hardware and software development
- Seed Research and Development
- Bio-technology
- R&D of new chemical entities in the pharmaceutical sector
- Hotel-cum-convention centre with seating capacity > 3000
- Production of bio-fuels
- Dairy and poultry industry
- Infrastructure sector (As defined in ECB regulations)

# FVCI - FDI related aspects



- As per the Consolidated FDI policy read with Schedule I of FEMA 20
- FVCIs to invest in VCU under FDI scheme as non-resident entities; subject to norms of the Consolidated FDI policy and FEMA regulations
- FDI in VCF in form of company under automatic route and subject to minimum capitalization norms; in form of Trust, permitted only with prior FIPB approval



# FVCI - Key Benefits & Concerns

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| Benefits | Concerns |
| --- | --- |
| • FDI / FEMA Pricing guidelines do not apply for investment/ divestment<br>• Post IPO lock-in of 1 year as per SEBI ICDR regulations not applicable to FVCI<br>- Provided not considered a Promoter<br>- Shares held > 1 year from filing of draft prospectus<br>• Regarded as QIB by SEBI<br>• Takeover Code regulations not applicable | • Interpretation issues surrounding Pass / through Tax exempt entity status under Section 10(23FB)<br>• Infrastructure definition of ECB v. Income Tax - Key differences being Power, Industrial Park, Telecommunication, etc not eligible for Income Tax benefits under Section 10(23FB)<br>• Investment in listed securities, whether primary or secondary, not permissible under Schedule 6 of FEMA Inbound Regulations though permitted under SEBI regulations<br>• RBI restrictions on FVCI investments except in permitted 9 Sectors<br>• Restriction on investment in debt/ listed shares<br>- ECB guidelines arguably should not apply to debt / debt instruments? |

# Recent Changes

By CA. Sudha G. Bhushan

# Qualified Foreign Investors (other than FIIs and FVCIs)

- Qualified Foreign Investors [RBI A. P (Dir Series) Circular No. **8 dated 9 August 2011**]
  - All non-residents investors other than SEBI registered FIIs and FVCIs
  - Allowed to purchase on repatriation basis rupee denominated units of equity schemes of SEBI registered domestic Mutual Funds (DMF)
  - Two Routes
    - **Direct Route** - SEBI registered Depository Participants Route [single INR account to be maintained by DP]
    - **Indirect Route** - Unit Confirmation Receipt (UCR) Route [DMF to open bank account outside India]
  - Overall ceiling of USD 10 billion to be monitored by SEBI
  - Direct issue of units by MF - secondary market purchases not allowed
  - QFIs to be from compliant jurisdictions
  - DPs and Domestic MFs to undertake KYC of QFI
  - Dividends to be directly remitted to the QFI by the DMF

## RBI/2011-12/452 A.P. (DIR Series) Circular No.93

FVCIs can invest in the eligible securities (equity, equity linked instruments, debt, debt instruments, debentures of an IVCU or VCF, units of schemes / funds set up by a VCF) by way of private arrangement / purchase from a third party

SEBI registered FVCIs allowed to invest in securities on a recognized stock exchange subject to the provisions of the SEBI (FVCI) Regulations, 2000

# Budget Effect

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# The Vodafone Effect

- Any **share or interest in a company** or entity registered or incorporated outside India shall be deemed to be and shall always be deemed to have been situated in India if the share or interest derives, directly or indirectly, **its value substantially from the assets located in India.**

-

- Amend definition of Capital asset to clarify that 'property' includes and shall be deemed to have always included any **rights in or in relation to an Indian company**, including rights of management or control or any other rights whatsoever.

- Section 2(47) '**transfer**' includes and shall be deemed to have always included disposing of or parting with an asset or any interest therein, or creating any interest in any asset in any manner whatsoever, directly or indirectly, absolutely or conditionally, voluntarily or involuntarily by way of an agreement (whether entered into in India or outside India) or otherwise, notwithstanding that such transfer of rights has been characterized as being effected or dependent upon or flowing **from the transfer of a share or shares** of a company registered or incorporated outside India.

- Amend section 195(1) to clarify that obligation to comply with sub-section (1) and to make deduction thereunder applies and shall be deemed to have always applied and extends and shall be deemed to have always extended to all persons, resident or non-resident, whether or not the non-resident has:-
  (a) a residence or place of business or business connection in India; or
  (b) any other presence in any manner whatsoever in India.

# Introduction of GAAR

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- (i) An arrangement whose main purpose or one of the main purposes is to obtain a tax benefit and which also satisfies at least one of the four tests, can be declared as an "impermissible avoidance arrangements".
- (ii) The four tests referred to in (i) are–
  - ❖ The arrangement creates rights and obligations, which are not normally created between parties dealing at arm's length.
  - ❖ It results in misuse or abuse of provisions of tax laws.
  - ❖ It lacks commercial substance or is deemed to lack commercial substance.
  - ❖ Is carried out in a manner, which is normally not employed for bonafide purpose.
- iii) It shall be presumed that obtaining of tax benefit is the main purpose of an arrangement unless otherwise proved by the taxpayer.

## "impermissible avoidance arrangements"

An arrangement will be deemed to lack commercial substance if –
(a) the substance or effect of the arrangement as a whole, is inconsistent with, or differs significantly from, the form of its individual steps or a part; or
(b) it involves or includes -
round trip financing;
an accommodating party ;
elements that have effect of offsetting or cancelling each other; or
a transaction which is conducted through one or more persons and disguises the value, location, source, ownership or control of fund which is subject matter of such transaction; or
(c) it involves the location of an asset or of a transaction or of the place of residence of any party which would not have been so located for any substantial commercial purpose other than obtaining tax benefit for a party.

# Venture capital Fund/Venture capital Company

**Extant Provisions**

Section 10(23FB) grants exemption in respect of income of such VCF/VCC in case investment is made by such VCC/VCF in unlisted shares of a domestic company, i.e. a Venture Capital Undertaking (VCU) in nine specified business. Section 115U ensures that income, in the hand of the investor through VCF/VCC is taxed in like manner and to the same extent as if the investment was directly made by investor in the VCU. Further, TDS provisions are not applicable to any payment made by the VCF to its investor and payment by VCC to the investor is exempted from Dividend Distribution Tax (DDT).The working of VCF, VCC or VCU are regulated by SEBI and RBI.

**Revised Provisions**

Amendment of Section 10(23FB) and Section 115U to provide that-

- The venture Capital undertaking shall have same meaning as provided in relevant SEBI regulations and there would be no sectoral restriction.
- Income accruing to VCF/ VCC shall be taxable in the hands of investor on accrual basis with no deferral.
- VCF/ VCC shall be required to deduct TDS while payment to investors.

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# Taxation of FII????

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