

Corpsec Hotline

May 30, 2008

FINALLY...

SEBI on May 29, 2008 finally brought into effect the long overdue and much anticipated amendments to the FII regulations, vide notification dated May 29, 2008, concerning the policy measures which it had announced on October 25, 2007. The broad policy changes announced last year covering *inter alia*, the definition of broad based sub-account, track record requirement for new funds, perpetual registration, clampdown on issuance of Offshore Derivative Instruments ("ODI") etc. have been made effective and formally included in the FII regulations with this amendment. Apart from the changes covering the policy measures announced in October 2007, SEBI has also introduced certain new changes to the FII regulations. The broad changes made to the regulations apart from those announced on October 25, 2007 are as follows:-

- New definition of sub-account: "any person 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 these regulations"

Implication: The definition of broad based sub-account has been enlarged to make it an inclusive definition. Thus, in the future SEBI may introduce certain new kinds of sub-accounts.

- Categories of foreign institutional investors-
 - Sovereign Wealth Funds have been included.
 - Nominee company has been removed.
 - Power of attorney holder has been removed.
- Amongst the conditions to be fulfilled for registering university fund, endowments, foundations, charitable trusts or charitable societies, another condition has been added- "whether the applicant has been serving public interest".

Implication: This gives a wide discretionary power to SEBI to consider applications based on whether they are serving any public interest or not.

- Categories of sub-accounts- SEBI has also amended the different categories of sub-accounts. The new categories of sub-accounts are as follows:
 - Broad based sub-account or portfolio which is broad based, incorporated or established outside India;
 - Proprietary fund of a registered foreign institutional investor;
 - Foreign corporate being a body corporate established outside India, which fulfills the following conditions:
 - whose securities are listed on a stock exchange outside India;
 - which has asset base of not less than USD 2 billion;
 - which had an average net profit of not less than USD 50 million during the three financial years preceding the date of the application.
 - Foreign individual being a foreigner who fulfills the following conditions:
 - Has a networth of not less than USD 50 million;
 - Holds the passport of a foreign country for a period of at least 5 years preceding the date of application;
 - Holds a certificate of good standing from a bank;
 - Is the client of the foreign institutional investor or any other entity which belongs to the same group as the foreign institutional investor, for a period of atleast 3 years preceding the date of application.
 - Non-resident Indian shall not be eligible to apply as sub-account.

Implications: Though SEBI has formally opened the gates for foreign corporate and foreign individual sub-accounts, which can now be registered, we do not foresee many applications coming considering the onerous eligibility conditions imposed by SEBI. Further, SEBI has also removed the restriction imposed on OCBs from registering as FIIs and sub-accounts. Thus NRI owned investment managers will now be given a free way for registering as a foreign institutional investor, albeit not as a sub-account.

- Investments by FII / sub-accounts:
 - SEBI has also introduced another form of security available for investments by FIIs and sub-accounts. FII and

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sub-accounts have henceforth been allowed to invest in units of scheme floated by a Collective Investment Scheme.

Implications: FII and sub-accounts can now invest in art funds and other funds set up under the Collective Investment Scheme Regulations.

- Investments made by FII or sub-account in equity shares in an unlisted company and the company subsequently going in for an IPO, such shares shall be subject to a lock-in for the same period, if any, as applicable to shares held by a foreign direct investor.
- Offshore Derivative Instruments: SEBI vide its press announcement dated October 25, 2007 had put certain crackdowns on the issuance of ODIs by FIIs and sub-accounts. Most of the announcements made that time have officially been enacted into the regulations with certain new additions as follows:
 - The definition of ODIs has been changed to- *“any instrument, by whatever name called, which is issued overseas by a FII against securities held by it that are listed or proposed to be listed on any recognized stock exchange in India, as its underlying.”*
 - ODIs can now be issued only to persons who are regulated by an appropriate foreign regulatory authority. Further, the FII shall ensure that no further issue or transfer is made of any ODI issued by or on behalf of it to any person other than a person regulated by an appropriate foreign regulatory authority. The regulations also describe a ‘Person regulated by an appropriate foreign regulatory authority’ to include the following:
 - Any person that is regulated/supervised and licensed/registered by a foreign central bank;
 - Any person that is registered and regulated by a securities or futures regulator in any foreign country or state;
 - Any broad based fund or portfolio incorporated or established outside India or proprietary fund of a registered FII or university fund, endowment, foundation, charitable trust or charitable society whose investments are managed by a person covered by any one of the above two conditions.

Implications: ODIs can now be issued to/ subscribed by and transferred to regulated entities or broad based or proprietary funds managed by regulated entities as described above. This will have serious implications on many entities which were earlier considered as regulated under SEBI Circular dated February 19, 2004, which under the present criteria may not conform to the definition of being regulated. Thus, such entities which were initially subscribing to ODIs may now have to wind up their investments.

- With respect to the issuance of ODIs linked to a percentage of the assets under custody (“**AUC**”), it has now been provided that additional ODIs can be issued against the bonus shares allotted in respect of the equity shares against which ODIs are already in existence.
- AUC has also been defined as- *“on a particular date, in relation to a FII or a sub-account, means the value of assets of the FII which are in custody of its custodian.”*

The changes to the regulations which are in pursuance to the October 25 announcement are as follows:

- Track record requirements- In case of a newly set up fund, the track record of the investment manager of the fund who has promoted it may be taken into consideration.
- Regulated requirements- It is no more imperative for university funds, endowments, foundations, charitable trusts and charitable societies to be regulated for foreign regulatory authorities to be considered for the purpose of registration.
- Broad based criteria- The definition of a broad based fund has been modified to include entities having at least 20 investors with no single investor holding more than 49%. This criteria is applied on a look through basis.

Implication: Thus, a fund can now be registered as a broad based sub-account with just 3 investors of which two can be non-institutional investors holding not more than 49% each and the remaining investment to be held by an institutional investor.

- Perpetuity of registration- Henceforth, FII and sub-account registrations have been made perpetual.

Though the regulations have come in after a long time since the policy announcement by SEBI, they have brought in force much more clarity and openness to the FII regulations. These amendments will seek to ameliorate the present status of NRI/OCB owned fund managers who had applied for FII registration and their registration was pending or had been cancelled, by doing away with the negative qualifications on NRIs and OCBs to be registered as FIIs or sub-accounts. Further, the regulations as discussed above have also opened the window officially for foreign corporate and foreign individual sub-accounts albeit with certain onerous conditions which may ensure that not many applications are filed under the foreign corporate and foreign individual category.

We understand that you may have a lot of queries on the amendments. Thus, we propose to hold a worldwide conference call on Monday, June 2, 2008 at 7 PM India time, to discuss these issues and address any queries which you may have. The dial-in details are as provided below. You are invited to join the conference.

Date: **2-June-2008**

Start Time: **19:00 hrs**

| DIAL IN NUMBERS | PASS CODE |
|------------------|-----------|
| +91 22 6629 0000 | 8351132# |

Please note:

- All the participants will be connected in Mute mode.

- The Guests will hear a hold music until the Speaker enters the call
- When instructed by the Speaker, the operator will conduct the Question & Answer Session.
- The Operator will request participants to **press * and 1** to ask questions to the Speaker.

Sources: *SEBI Circular*

- Divaspati Singh, Suneet Barve & Kishore Joshi
You can direct your queries or comments to the authors

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