Report of the Working Group on Foreign Investment

30 July 2010

Department of Economic Affairs
Ministry of Finance
New Delhi India

Report of the Working Group on Foreign Investment

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New Delhi,30July,2010

The Finance Secretary
Ministry of Finance
Government of India, North Block
New Delhi - 110001

Dear Sir,

We submit herewith a report of the Working Group on Foreign Investment.

Yours sincerely,

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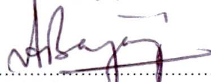
Fmr Joint Secretary (Capital Markets),DEA
Presently, Secretary, PM's Economic Advisory Council

Shri Ashutosh Dikshit
Joint Secretary (Tax Policy and Legislation-I),DoR

Shri Govind Mohan
Joint Secretary (Infrastructure and Investment),DEA

Shri K. N Vaidyanathan
Executive Director (SEBI)



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Director (Secondary Markets) .DEA

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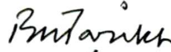

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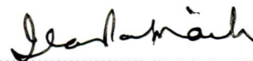

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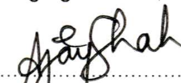

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Founder Director, AZB & Partners

F.No. 10/5/ECB-2009
Ministry of Finance
Department of Economic Affairs
(Capital Markets Division)

North Block, New Delhi
19th November, 2009.

OFFICE ORDER

Sub: Working group on Foreign Investment in India.

With a view to rationalising the present arrangements relating to foreign portfolio investments by Foreign Institutional Investors (FIIs)/ Non Resident Indians (NRIs) and other foreign investments like Foreign Venture Capital Investor (FVCI) and Private Equity entities etc, it has been decided to set up a working group with the following composition:

1.	Shri U K Sinha, CMD, UTI Asset Management Company, Chairman
2.	Dr. K.P. Krishnan, Joint Secretary(CM), Member
3.	Shri Arbind Modi, JS(TPL) Member
4.	Shri Govind Mohan , JS(I&I) Member
5.	Shri K.N. Vaidyanathan , Executive Director, SEBI, Member
6.	Shri A.M. Bajaj, Dir(EM), Member
7.	Shri C.K.G. Nair, Dir(PM), Member
8.	Shri C.S. Mohapatra, Dir(SM), Member
9.	Shri P.K. Bagga, OSD (CM&I), Member
10.	Prof Ajay Shah, NIPFP-DEA research programme, Permanent Invitee
11.	Prof Ila Patnaik, NIPFP-DEA research programme, Permanent Invitee
12.	Shri Ravi Narain, Managing Director & CEO, NSEIL, Permanent Invitee
13.	Shri Bahram Vakil, Founder Director, AZB & Partners, Permanent Invitee
14.	Shri Bobby Parikh, Managing Partner, BMR Advisors, Permanent Invitee
15.	Shri Anand Pathak, Managing Partner, P&A Law Offices, Permanent Invitee
16.	Shri Somasekhar Sundaresan, J. Sagar Associates, Permanent Invitee

2. The Terms of Reference (TOR) of the working group will be as follows:

i. To review the existing policy on foreign inflows, other than Foreign Direct Investment (FDI), such as foreign portfolio investments by Foreign Institutional Investors (FIIs)/ Non Resident Indians (NRIs) and other foreign investments like Foreign Venture Capital Investor (FVCI) and Private equity entities and suggesting rationalisation of the same with a view to encourage foreign investment and reducing policy hurdles in this regard while maintaining the Know Your Customer (KYC) requirements.

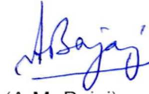
ii. To identify challenges in meeting the financing needs of the Indian economy through the foreign investment. Foreign investment for this purpose to be understood broadly and can include investment in listed and unlisted equity, derivatives and debt including the markets for government bonds, corporate bonds and external commercial borrowings.

iii. To study the arrangements relating to the use of Participatory Notes and suggest any change in the policy if required from KYC and other point of view.

iv. To reexamine the rationale of taxation of transactions through the STT and stamp duty.
v. To review the legal and regulatory framework of foreign investment in order to identify specific bottlenecks impeding the servicing of these financing needs.
vi. To suggest specific short, medium and long term legal, regulatory and other policy changes in respect to foreign investment keeping in view of the suggestions expert committee reports such as the Committee on Fuller Capital Account Convertibility, the Committee on Financial Sector Reforms and the High Powered Expert Committee on Making Mumbai an International Financial Centre.
vii. Any other matter the working group may consider relevant.

3. CM Division will provide administrative support to the Working Group. Expenditures as may be required for the activities/ meeting etc. of the working group shall be met by the National Institute of Public Finance and policy (NIPFP) out of the NIPFP-DEA research programme funds. The NIPFP-DEA research programme team will also provide appropriate research assistance to the working group.

4. The working group shall submit its report to Ministry of Finance within four months.



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7. Shri C.K.G. Nair, Dir(PM)
8. Shri C.S. Mohapatra, Dir(SM)
9. Shri P.K. Bagga, OSD (CM&I)
10. Shri Ravi Narain, Chairman and Managing Director, National Stock Exchange of India
11. Prof Ajay Shah, NIPFP
12. Prof Ila Patnaik, NIPFP
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14. Shri Bobby Parikh, Managing Partner, BMR Advisors, Mumbai
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Copy for information to:
1) Governor , RBI
2) FS
3) Chairman, SEBI
4) Director, NIPFP

F.No. 10/5/ECB-2009
Ministry of Finance
Department of Economic Affairs
(Capital Markets Division)

North Block, New Delhi
March 3, 2010.

OFFICE ORDER

Sub: Working group on Foreign Investment in India.

This is in continuation of this Department's Office Order of even number issued on 19th November,2009 on the above mentioned subject. The composition of working group on foreign investment in India now includes the following:

1.	Shri U K Sinha, CMD, UTI Asset Management Company, Chairman
2.	Dr. K.P. Krishnan, Joint Secretary(CM), Member
3.	Shri Ashutosh Dikshit, JS(TPL) Member
4.	Shri Govind Mohan , JS(I&I) Member
5.	Shri Gopal Krishna, JS (DIPP)
6.	Shri K.N. Vaidyanathan , Executive Director, SEBI, Member
7.	Shri A.M. Bajaj, Dir(EM), Member
8.	Shri C.K.G. Nair, Dir(PM), Member
9.	Shri C.S. Mohapatra, Dir(SM), Member
10.	Shri P.K. Bagga, OSD (CM&I), Member
11.	Shri Ravi Narain, Managing Director & CEO, NSEIL, Permanent Invitee
12.	Shri Madhu Kannan, Managing Director & CEO, Bombay Stock Exchange, Permanent Invitee
13.	Prof Ajay Shah, NIPFP-DEA research programme, Permanent Invitee
14.	Prof Ila Patnaik, NIPFP-DEA research programme, Permanent Invitee
15.	Shri Bahram Vakil, Founder Director, AZB & Partners, Permanent Invitee
16.	Shri Bobby Parikh, Managing Partner, BMR Advisors, Permanent Invitee
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1. Shri U K Sinha, CMD, UTI Asset Management Company, Chairman
2. Dr. K.P. Krishnan, JS(CM), Department of Economic Affairs
3. Shri Ashutosh Dikshit, JS(TPL)

4. Shri Govind Mohan , JS(I&I)
5. Shri Gopal Krishna, JS (DIPP)
6. Shri K.N. Vaidyanathan , Executive Director, SEBI
7. Shri A.M. Bajaj, Dir(EM)
8. Shri C.K.G. Nair, Dir(PM)
9. Shri C.S. Mohapatra, Dir(SM&IC)
10. Shri P.K. Bagga, OSD (CM&I)
11. Shri Ravi Narain, Chairman and Managing Director, National Stock Exchange of India
12. Shri Madhu Kanan, Managing Director & CEO, BSE
13. Prof Ajay Shah, NIPFP
14. Prof Ila Patnaik, NIPFP
15. Shri Bahram Vakil, Founder Director, AZB & Partners, Mumbai
16. Shri Bobby Parikh, Managing Partner, BMR Advisors, Mumbai
17. Shri Anand Pathak, Managing Partner, P&A Law Offices, New Delhi
18. Shri Somasekhar Sundaresan, J. Sagar Associates, Permanent Invitee

Government of India
Ministry of Finance
Department of Economic Affairs
Capital Markets Division

PRESS RELEASE

Working Group on Foreign Investment in India

With a view to rationalising the present arrangements relating to foreign portfolio investments by Foreign Institutional Investors (FIIs)/ Non Resident Indians (NRIs) and other foreign investments like Foreign Venture Capital Investor (FVCI) and Private Equity entities etc., the Government has decided to set up a working group to look at various types of foreign flows, which are taking advantage of arbitrage across the respective stand-alone regulations and generate recommendations to Government. The working group consists of members from the Government, the regulators and the private sector. Its composition and the office order is available at the following links: http://finmin.nic.in/ (in the recent updates column) and http://www.nipfp.org.in/nipfp-dea-program/misc.html

2. The terms of reference of the working group draw attention to the following:

i. To review the existing policy on foreign inflows, other than Foreign Direct Investment (FDI), such as foreign portfolio investments by Foreign Institutional Investors (FIIs)/ Non Resident Indians (NRIs) and other foreign investments like Foreign Venture Capital Investor (FVCI) and Private equity entities and suggesting rationalisation of the same with a view to encourage foreign investment and reducing policy hurdles in this regard while maintaining the Know Your Customer (KYC) requirements.

ii. To identify challenges in meeting the financing needs of the Indian economy through the foreign investment. Foreign investment for this purpose to be understood broadly and can include investment in listed and unlisted equity, derivatives and debt including the markets for government bonds, corporate bonds and external commercial borrowings.

iii. To study the arrangements relating to the use of Participatory Notes and suggest any ' change in the policy if required from KYC and other point of view

iv. To re-examine the rationale of taxation of transactions through the STT and stamp duty.
v. To review the legal and regulatory framework of foreign investment in order to identify specific bottlenecks impeding the servicing of these financing needs.
vi. To suggest specific short, medium and long term legal, regulatory and other policy change;" in respect to foreign investment keeping in view of the suggestions expert committee reports such as the Committee on Fuller Capital Account Convertibility, the Committee on Financial Sector Reforms and the High Powered Expert Committee on Making Mumbai an International Financial Centre.
vii. Any other matter the working group may consider relevant.

3. Comments of industry associations, bodies and individuals on the issues involved in the office order are invited by 10th February, 2010 to be sent to the National Institute of Public Finance and Policy ("NIPFP"), 18/2 Satsang Vihar Marg, Special Institutional Area (Near JNU), New Delhi 110067, INDIA or at email id nipfp.wgpf@gmail.com

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F. No. 10/5/ECB-2009 Dated: January 13, 2010

The press Information Bureau is requested to give wide publicity to this Press Release.

(Dr. K. P. Krishnan)
Joint Secretary to the Government of India

Press Information Officer
Press Information Bureau
Shastri Bhawan
New Delhi.

Copy to:

1. The Director (Technical), NIC, North Block, New Delhi for placing the press release on MOF's website.

(Dr. K. P. Krishnan)
Joint Secretary to the Government of India

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Members	
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Ashutosh Dikshit	Joint Secretary (Tax Policy and Legislation-1) Central Board of Direct Taxes, Ministry of Finance
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Foreword

It has been an honour to lead, on behalf of the Government of India, a working group on foreign investments in the country. The terms of reference of this working group gave us a wide mandate on matters concerning capital flows (other than foreign direct investment). In the last few years, we have had major committee reports, led by the leading minds in Indian public policy, looking at questions ranging from capital account convertibility to the next generation of financial reforms to bond market regulation etc. The working group, therefore, attempted to have a serious discussion of the law and regulation in the areas of capital flows and also on the structures of governance that would optimise policy performance within whatever framework of capital account may be envisioned by the Government, in the context of that larger policy evolution.

This report examines foreign investment law and capital flow management policy as it is manifested in the norms, institutions and processes of law. The Group examined the structure of regulation and the ways in which practices, institutions and procedures inflect and shape these policy decisions. The report also offers, along side an economic policy piece contextualising these flows in relation to the Indian and global economy, close scrutiny of the structures and incentives created by the law in the main areas of our mandate; capital flows management regulations with regard to listed and unlisted equity, corporate and government securities regulation and derivatives trading. The focus of the Group has been to identify procedures and practices which can help avoid uncertainty, delay or unequal treatment and to recommend measures which could simplify the portfolio investment environment; at the same time laying a strong emphasis on KYC norms.

Consultation was important to us. This working group held six formal meetings, including an open public hearing, and had many informal discussion sessions. We invited the participation of the Reserve Bank of India. Salim Gangadharan, Chief General Manager-in-Charge and Aditya Gaiha, Deputy General Manager, Foreign Exchange Department, RBI, participated extensively in one of our formal meetings. We had a session in Mumbai where representatives from 14 organizations came forward with their suggestions. Finally, we had an open comment process. In particular, we posted requests for feedback on the Internet and actively solicited discussion from major institutional stakeholders. The feedback we received was extensive and has enriched both this report as well as the ongoing deliberations of the Ministry of Finance, to whom we have also submitted this material.

Finally, I would like to thank all those whose contributions have enriched this report. Members made spirited, generous and innovative contributions to our collective discussions and gave extensively of their time in reviewing the text and findings

of this report. K.P. Krishnan offered clarity and understanding of both legal institutions and economic policy. Ashutosh Dikshit anchored our discussions of tax policy and contributed broadly to the report. The time and attention given by Gopal Krishna and Govind Mohan is greatly appreciated. K.N. Vaidyanathan brought deep knowledge of capital markets to our discussions. He also worked with Salim Gangadharan to develop our thinking with regards to consumer protection matters and outflows of capital. The directors of the Capital Markets Division, A.M. Bajaj, P.K. Bagga, C.S. Mohapatra and C.K.G. Nair provided close and incisive readings of our report and brought a depth of knowledge about the Foreign Exchange Management Act ("FEMA") and the institutional history of recent financial sector reforms that has been invaluable.

Madhu Kannan helped us think about country comparisons and made important contributions to our thinking on dual listing. Ravi Narain was very generous with his time and helped crystallise the group's thinking on rupee-denominated debt. Ajay Shah and Ila Patnaik contributed on matters of market functioning, institutional design, and macroeconomics, particularly questions of India's integration into the global economy.

The lawyers and legal specialists who contributed to this document were obviously crucial to our deliberations. Somasekhar Sundaresan, Bahram Vakil, Bobby Parikh and Anand Pathak made vital contributions to our thinking about appellate review, the relationship between FDI policy and portfolio investment, consumer protection standards and on foreign exchange regulation and tax policy.

I would also like to thank the Secretariat, the Macro/Finance Group at the National Institute of Public Finance and Policy ("NIPFP"). Bikku Kuruvila, the leader of this team, Shubho Roy, Vimal Balasubramaniam and Radhika Pandey poured an enormous number of hours into the meetings and preparation of this report. Their background work, drafting, legal analysis and policy research on wide and diverse areas of Indian law, country comparisons and the extent of India's integration into the global economy provided strong foundations for our deliberations and the final report. Shefali Dhingra of the Ministry of Finance exhibited managerial savvy in keeping the group moving forward. Her efforts are very much appreciated.

M. Govinda Rao, Director, NIPFP and Kavita Rao, NIPFP, quite generously agreed to brief the working group on the economics of source-based and global residency based taxation.

Roshni Shanker and Prateek Shroff, formerly of NIPFP, put in long hours at early stages of the report and helpfully proof-read drafts of the report for us.

Both Ravindra Mohan Bathula and Arjun Krishnan provided us with important feedback and insights on large and small questions of legal due process and foreign exchange regulation.

We'd like to thank the participants of an August 2009 NIPFP conference titled *Next Steps in Policy on Capital Flows*, which helped in the preparatory work of this Working Group, which included Vishal Belsare, S. Khasnobis, Jayesh Mehta, Zia Mody and P.R. Suresh.

Thanks also to Vishal Agarwal, Varoon Chandra, Manisha Chavan, Ketan Dalal, Devika Das, Supriyo De, Brian Fernandes, Akash Gupt, Jaitra Jani, Madhav Kanhere, Shagoofa Khan, Neha Mohan, Kiran Nisar, Mrugank Paranjape, Ashwath Rau, Abhinav Sanghi and Essaji Vahanvati for their gracious assistance and inputs at different stages of the report.

U.K. Sinha, July 30, 2010

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CHAPTER 1

Executive summary

Expert committees such as the Committee on Fuller Capital Account Convertibility, the Committee on Financial Sector Reforms and the High Powered Expert Committee on Making Mumbai an International Financial Centre have provided broad, overarching views of the role, consequences and timeline for thinking about capital account convertibility in India. In this context, the group focused pointedly on the structure of regulation and rationalizing the instruments, arrangements and programs through which India regulates capital flows. The working group strongly felt that paying attention to the organization of regulation would yield strong dividends to the economy in the form of more clear, certain and ultimately more effective regulation. Consequently, our recommendations are intended to replicate existing policy postures with regard to capital flows while reducing costs, complexity and legal uncertainty in terms of the law.

In this light, the working group first reviewed questions of the rule of law and investigated the concrete manifestation of India's protection of values such as accountability, fairness, transparency, participation and quality of law, both in its formulation and in its administration, in specific areas of financial regulation. The working group then reviewed substantive law and broad policy concerns affecting investment in listed and unlisted equity, the markets for corporate and government securities and derivatives. Looking at the meaning and implications, in detail, of foreign exchange regulation of equity and debt markets, along with derivatives trading, is of course the substance of any significant exploration of capital flows management law. Foreign direct investment or "FDI" policy was not part of the mandate of this group, though the working group did examine areas where the line between FDI and portfolio investment policy is not clear.

We also studied closely questions of tax policy. Tax policy is an important consideration in the investment decisions of market participants. By foregrounding the interrelationship of tax policy and the regulation of foreign investment, the working group feels that we will have made a contribution to policy discourse.

1.1. India's internationalisation

Any substantive examination of the structure of capital flows management regulations requires some understanding of macroeconomic context. We looked at many factors that could contextualize India's engagement with the world economy and

the concomitant role of capital flows management. These factors include: country comparisons with similarly placed nation-states, levels of integration as measured by gross flows on the current and capital accounts, fears of capital flight and empirical estimates of the significance thereof, corporate fraud and investor perceptions of the resilience of Indian institutions and the recent global economic crisis.

First, for comparisons sake, we looked at the structure of regulation in Brazil, South Africa, South Korea and Turkey, what we call the "BSST" nations as well as China, Russia, and at times, OECD countries. We focused on the BSST nations in particular for their examples of countries with large domestic markets and democratic governance. The BSST cohort has also attempted reforms in their foreign investment framework over recent years. The working group feels that given the comparable demographic and institutional profiles of these nations, these comparisons of legal frameworks would be quite telling.

The working group then studied macroeconomic indicators to study the level of integration of the BSST nations and India. India's gross investment position on the current account rose by 23 percentage points in the 1990s, and an additional 40 percentage points from 2000 to 2008. The gross investment position on the capital account, excluding foreign exchange reserves, rose by 12 percentage points from 1990 to 1998. This rose by 43 percentage points from 2000 to 2008. India's integration with the global economy can be compared to the BSST cohort in the latter half of the period of liberalization, from 2000 to 2008. Firm level analysis show that foreign engagement in terms of imports, exports, foreign equity, foreign borrowing and overseas assets have grown roughly tenfold both by size and by number of listed firms.

India's foreign investment framework has been influenced by perceptions that foreign investment is volatile and could respond sharply to adverse domestic events, thus exacerbating a domestic crisis. The working group assessed the possibility of *en masse* exit by looking at foreign investors response to significant recent events such as the 26/11 Mumbai attacks, the attack on Parliament of 2001, the Gujarat riots of 2002 and the formation of the UPA government. Our analysis showed that the greatest exit by foreign investors was actually seen after the Lehman crisis of September 2008, an international event with causes beyond India's boundaries. To us, while the likelihood of large scale exit by foreign investors is a possibility, it is unlikely.

In terms of the role of corporate governance, India's institutions also appear resilient and able to help attract foreign investment. When accounting fraud was disclosed by the then Satyam Computer Services Ltd, foreign investors did not appear to generalize from these events to India at large. There was no large-scale exit by foreign investors from India.

Finally, looking at the recent global economic crisis, when the Lehman bankruptcy took place, the operating procedures of monetary policy came under stress. Monetary policy was unable to keep the call money rate from going well beyond the repo and the reverse repo rate. Indian multinationals operating global treasuries appear to have been a conduit between global events and domestic money markets. The emergence of internationalised firms – with imports, exports, foreign equity investors, foreign debt, and overseas assets – thus represents a new phase in India's integration with the world economy.

If India's foreign investment framework has been shaped by perceptions of foreign capital flows as threat, the working group's analyses of the country's internationalisation suggests that Indian actors have embraced and internalized foreign participation in the economy and that foreign participation is deep-rooted.

1.2. Legal process

While most of the legal policy sections of this report focus on rationalizing the substance of capital flows management regulation, this section focuses on rationalizing the *process* of such regulation. Foreign exchange regulation thus far has been seen as an instrument of monetary policy. To the extent that the application of this law affects the ability and extent of individual actors to participate in markets, these rules are a significant part of financial sector regulation. As such, the best practices and basic principles of due process and rule of law that apply to other areas of regulation, including financial sector regulation, should apply to these matters as well.

Stated differently, agencies act in a regulatory capacity when they enforce applicable laws and regulation. The working group believes firmly that agencies acting in a regulatory capacity should respect and protect basic principles of legal due process. Registrations, licenses and other permissions create or allow important economic opportunities for regulated entities. Denials of such should be done with transparency and explicit reasoning.

Seen in this light, legal processes are the concrete manifestation of rule of law. The working group insists that rule of law includes formalized procedures for transparency and legal certainty, participation as well as accountability, fairness and equality before the law. Procedures giving meaning to these terms include processes of consultation as well as judicial review of disputes. Rule of law also takes meaning in matters such as information management and access to the letter of the law. Rule of law is also given substance through considerations of the quality of law which includes the importance given to the departments that formulate these rules.

Our major legal process recommendation are to:

1. Respect and protect basic principles of legal due process when agencies apply foreign investment or foreign exchange law to individual market participants;
2. Create a financial sector appellate tribunal, or extend the authority of the Securities Appellate Tribunal, to hear appeals on all aspects of capital flows management regulations;
3. Institute processes of required public consultation before issuing any directives of law and policy. In general, the working group urges the creation of transparent and approachable frameworks for access to the administrators of financial regulation for interpretation and clarity in areas of ambiguity.
4. Involve law departments more integrally in the formation of policy;
5. Create more user-friendly access to the law through public information systems. This should include provision of real-time access to comprehensive statements of law as well as decisions and reasoned orders of appellate tribunals with regard to securities matters.

1.3. Qualified Foreign Investor: A single window for portfolio investment

Listed and unlisted equity in India have received focused regulatory attention since the establishment of the Securities Exchange Board of India ("SEBI") in 1992. In particular, SEBI's Foreign Institutional Investors ("FII") Regulations, 1995 and subsequent amendments opened much room for foreign investment into listed and unlisted equity in India. The regulations facilitated the regulation of institutional investors, the primary investors at that level of integration into the world economy and reflected India's calibrated opening to world markets.

Yet, when examined from the perspectives of market participants today, foreign investors face an ad hoc system of sometimes overlapping, sometimes contradictory and sometimes non-existent rules for different categories of players that, in turn, has created problems of regulatory arbitrage and lack of transparency and create onerous transaction costs. These transactions costs increase the cost of capital faced by Indian recipients of foreign equity capital. Furthermore, the working group also questions whether present regulatory frameworks are complete and sufficient to track investments into the economy for purposes of addressing concerns related to money laundering and terrorist financing.

Multiple government committees such as the Committee on Fuller Capital Account Convertibility and the Report of the Committee on Financial Sector Reforms have commented on broad and specific levels about the ad hoc structure of India's capital flows management. Notably, the Committee on Fuller Capital Account Convertibility or Tarapore Committee has recommended the creation of a framework where all individual non-residents would be allowed to invest in the Indian stock market through SEBI registered entities who would be responsible for meeting Know Your Client/Customer ("KYC") norms.

In this context, this working group proposes a restructuring and rationalization of the administration of capital flows management regulations. In particular, the working group recommends a single window for registration and administration of portfolio investment regulations, what we call Qualified Foreign Investors ("QFI"). In such a framework, qualified depository participants ("DPs"), with global presence through branch network or agency relationships would be legally responsible for enforcing OECD-standard KYC requirements. Such global DPs would have higher capital requirements and would need to pass a detailed fitness test administered by SEBI.

The QFI framework would cut across asset classes with no distinction made between investor classes. FIIs, FVCIs and NRIs would be abolished as an investor class.

Generally speaking, investment into listed or unlisted securities at a level below 10 percent of shares would be considered portfolio investment. This is the current limit for FIIs which presumably would be extended to QFIs. Investment above 10 percent would be considered FDI and would require compliance with existing FDI rules, regulations and procedures. This is the standard OECD distinction and practice as well of peer countries such as Brazil, South Korea, South Africa and Turkey which have comparably sized domestic markets and democratic governance.

All regulated investment under FDI policy or other sectoral regulation such as regulation of mutual funds or pensions and takeover regulations under the Companies Act, would continue as before. Within the automatic route, there would be no distinction between FDI and portfolio investment.

The recommendations would leave unaltered, regulators ability to administer capital flows management regulations as well as the content thereof. The proposed reforms would make the administration of capital flows management regulations more straightforward and offer more certainty to markets in so doing. This framework would also replace the existing system of multiple investor classes that gives opportunities for regulatory arbitrage.

Of course, the working group notes that attention should also be paid to those areas where FDI and portfolio investment policy overlap. Regulations tailored to a particular type of institution, like non-banking finance companies or venture capital firms would require close review and possible modification before being imported or excluded from the framework of regulations for QFIs.

As such, our major recommendations regarding the framework and administration of capital flows are to:

1. Create a single window for registration and clearance of portfolio investment regulations that does not distinguish between investor classes.
    (a) Qualified depository participants ("DPs"), with global presence through branch network and agency relationships would be legally responsible for enforcing OECD-standard KYC requirements;
    (b) Such global DPs would have higher capital requirements and would need to pass a detailed "fitness test" administered by SEBI;
    (c) FIIs, FVCIs and NRIs would be abolished as an investor class.
2. Clarify that investment into listed or unlisted securities at a level below 10 percent of shares would be considered portfolio investment. Investment above 10 percent would be considered FDI and would require compliance with existing FDI rules, regulations and procedures;
3. Promulgate broader KYC requirements that meet Organisation for Economic Co-operation and Development ("OECD") standards of best practices. These requirements would combine adherence to Prevention of Money Laundering Act ("PMLA") rules and regulations as well as information required for market monitoring by all regulators of financial services into one master file;
4. Closely review sectors where limits set by FDI and portfolio investment policy overlap;
5. Consistent with Lahiri Committee recommendations, in areas where there are no separate ceilings by an Act of Parliament, QFI investment ceilings should be reckoned over and above prescribed FDI sectoral caps;
6. Examine closely areas where regulations tailored to a particular type of institution would be incorporated, modified or subsumed by the larger QFI framework. For example,
    (a) Grandfather existing FVCI investments to avoid business discontinuity for existing firms;
    (b) Consider amending the consolidated FDI Policy to exempt SEBI registered QFIs from seeking approval of the Government prior to investing in a DVF incorporated as a trust;
7. With regard to participatory notes, SEBI should have the final right to demand details about the end investor in cases of needed investigations;

1.4. Outflows into equity

The working group felt that policy consideration of outflows is important for reducing risk in India. Investing abroad offers Indian investors, all residents of India, reduced risk through diversification of holdings, though such investment is predicated upon appropriately strong consumer protection rules.

Under the Liberalised Remittance Scheme ("LRS"), residents in India are allowed to remit up to US $ 200,000 annually abroad. Currently, entities, whether foreign or Indian, that offer overseas investment products to residents do not have a regulatory framework to offer and market such investment avenues to investors resident in India.

The working group was particularly keen that consumer protection guidelines encompassing disclosure, transparency and fairness be set in place while permitting investments and trading in financial instruments overseas. As such, the working group

recommends that all entities structuring and offering securities market-related products in the overseas market, who offer these products to residents on Indian soil, should register with SEBI and fully disclose all details of the product, promotional materials, including product literature, advertisements and brochures which SEBI can also forward to other regulators.

1.5. Debt

The working group's observations of the government securities and corporate debt markets involve two inter-related phenomena; 'original sin' and the lack of institutional development of the corporate debt market. The group notes that exchange rate risks with foreign currency denominated borrowings – 'original sin' – as well as quantitative restrictions work against financial stability and limit financing options that would further promote the country's development. With regard to institutional development, the working group felt that developing the rules, systems and regulatory structure for a deep and liquid bond market would, though not directly a capital controls matter, attract foreign investment, promote a deep engagement of foreign investors with India, and help shield the economy from currency mismatches. Of course, the QFI model discussed in the context of equity should be available and provide a unified regulatory framework for debt investments.

Our major recommendations regarding debt are listed as follows:

1. Remove the caps on rupee-denominated corporate debt as a matter of addressing currency mismatches. Any desired restrictions on debt related capital flows could be expressed as a percentage of gross issuance instead of in absolute terms.
2. Finish implementing the many recommendations from government committee reports over the past five years that have either partially or not been implemented;
3. Extend the QFI model, our single window for clearance of portfolio investment regulations, to debt investments as well;
4. Extend consumer protection guidelines for investment in foreign securities under the Liberalised Remittance Scheme to investments in debt securities.

1.6. Derivatives

We offer a few first principles to guide these discussions that fall in the area where financial stability and foreign investment concerns overlap. First, the group reviewed the role and function of derivatives trading. The working group argues that derivatives trading has minimal balance of payments implications. While the risk structure of the economy is modified by derivatives trading, on an average day, the net capital moving in or out of the country tends to zero so long as the number of foreign market participants is large. Policy decisions about derivatives trading as a matter of prudential regulation should then be seen as a separate matter from the regulation of foreign investment. Second, the working group notes that with regard to the regulation of forwards and futures, allowing for participation in one route while banning the same in another merely redirects flows, invites regulatory arbitrage and may not have the intended effect. Third, the group found that position limits are intended to limit the ability of a market participant to engage in market manipulation. Accordingly, position limits should be crafted with market integrity in mind and be neutral to nationality. Finally, with regard to the use of offshore derivative instruments, the

working group acknowledges that greater onshore participation facilitates financial stability through the greater ability of regulators to supervise market practices. Yet, there are many reasons for trading in offshore derivative instruments that no national regulatory regime may be able to completely suppress. The creation of the QFI framework will go a long way, the working group feels, towards incentivising greater onshore participation in derivatives trading. As such, our main recommendations for derivatives policy are:

1. Capital flows management regulations should focus on spot instruments and not derivatives;
2. Harmonize the regulation of futures, forwards and options. There should be a general policy preference to encourage greater trade in exchange-traded, as opposed to over-the-counter derivatives;
3. Allow investment by Indian residents in derivatives trade abroad up to the US $200,000 limit under the Liberalised Remittance Scheme without further regulation. Specifically the ban on taking margin payments should be restated to hold that,when taking margin payments, total liability should not exceed the LRS limit;
4. Streamline registration processes by implementing the QFI model, as suggested above, to also reduce the incentives to participate in offshore markets such as those for participatory notes.

1.7. Tax

As discussed, the sea-change in India's level of integration with the world economy calls for a rethinking of the conceptual structures of tax policy with regard to foreign investment. Tax policy, as a practical matter, is irreducibly a part of the calculations made by investors in considering investments in India. India's system of source based taxation is predicated upon assumptions of the country being primarily and predominantly a recipient of capital flows. As India integrates further into the world economy, the working group believes that policy makers will have to examine the distortions that would develop in a country that is more integrated and the provider as well as recipient of capital flows. Decisions about investment should be driven purely by economic considerations of risk, return and liquidity, without any tax-induced distortions about the portfolio that is held, the financial intermediaries that are used, or the cities where transactions are placed. Whether India applies a securities transaction tax, a stamp duty, or a capital gains tax upon residents, integration with the world of international finance requires not applying a burden of taxation upon non-residents. Global residency based taxation would align Indian tax policy with international best practices and reduce incentives to direct financial services transactions to locations outside India. The working group also considers whether, if openness is a given, if India is already to a large extent integrated with the world economy, India's current system of source-based taxation would limit domestic financial development. With continued growth and shallow local financial markets, domestic market participants face rational decisions involving whether to direct capital abroad or not. These questions should be examined.

This working group understands that tax policy is a vast and complex affair and that drastic changes in regulatory framework should not be taken lightly. As such, the group calls on the Ministry of Finance to undertake further studies on these matters.

Our major recommendation regarding taxation and foreign investment, in short, is to study:

1. The revenue implications of shifting to a residence-based system of taxation;
2. The information technology systems and information sharing mechanisms with other countries which need to be in place to properly implement taxation of global income of residents in a residence-based taxation system for capital gains. A study of such mechanisms in BSST and OECD countries could be done;
3. The administrative issues and short-term revenue implications of shifting from a source-based to a residence-based system with attention to other countries experiences with such transitions;
4. The revenue and compliance advantages of source based taxation of capital gains and whether tax and compliance burden would actually reduce if countries followed a source based taxation regime for capital gains.

The working group recognises that the DTC along with the Revised Discussion Paper, if enacted in its present form, improves certainty on the question of permanent establishment for FIIs. The proposal to deem income of FIIs as income from capital gains should be broadened to cover all non-resident investors including private equity funds.

Further, a broader approach could also be considered so that fund managers become comfortable with offering financial services from Indian soil, for India-related and for global-scale fund management. For this, there needs to be clarity regarding the circumstances under which a fund manager in India handling the investments of a global fund located abroad would be held to be an "independent agent" and consequently would not constitute a PE in India. A suitable instruction or circular laying down the criteria to be used to determine "dependent" and "independent" agent status in the case of fund management services for global investors would provide a degree of certainty and would help in increasing fund management and advisory services out of India.

1.8. Recommendations summary

1.8.1. *Legal Process*

1. Respect and protect basic principles of due process when agencies apply foreign investment or foreign exchange law to individual market participants;
2. Create a financial sector appellate tribunal, or extend the authority of the Securities Appellate Tribunal, to hear appeals on all aspects of capital flows management regulations;
3. Institute processes of required public consultation before issuing any directives of law and policy. In general, the working group urges the creation of transparent and approachable frameworks for access to the administrators of financial regulation for interpretation and clarity in areas of ambiguity;
4. Involve law departments more integrally in the formation of policy;
5. Create more user-friendly access to the law through public information systems. This should include provision of real-time access to comprehensive statements of law as well as decisions and reasoned orders of appellate tribunals with regard to securities matters.

1.8.2. *QFI*

1. Create a single window for registration and clearance of portfolio investment regulations that does not distinguish between investor classes.
   (a) Qualified depository participants ("DPs"), with global presence through branch network and agency relationships would be legally responsible for enforcing OECD-standard KYC requirements;
   (b) Such global DPs would have higher capital requirements and would need to pass a detailed "fitness test" administered by SEBI;
   (c) FIIs, FVCIs and NRIs would be abolished as an investor class.
2. Promulgate broader KYC requirements that meet Organisation for Economic Co-operation and Development ("OECD") standards of best practices. These requirements would combine adherence to Prevention of Money Laundering Act ("PMLA") rules and regulations as well as information required for market monitoring by all regulators of financial services into one master file;
3. Closely review sectors where limits set by FDI and capital flows management policy overlap;
4. Consistent with Lahiri Committee recommendations, in areas where there are no separate ceilings by an Act of Parliament, QFI investment ceilings should be reckoned over and above prescribed FDI sectoral caps;
5. Examine closely areas where regulations tailored to a particular type of institution would be incorporated, modified or subsumed by the larger QFI framework. For example,
   (a) Grandfather existing FVCI investments to avoid business discontinuity for existing firms;
   (b) Consider amending the consolidated FDI Policy to exempt SEBI registered QFIs from seeking approval of the Government prior to investing in a DVF incorporated as a trust;
6. With regard to participatory notes, SEBI should have the final right to demand details about the end investor in cases of needed investigations;

7. Legal changes:
   (a) QFI
      i. SEBI FVCI and FII regulations would be replaced by a new QFI regulation;
      ii. FEMA (Transfer or Issue of Security by a Person Resident Outside India) Regulations, notably Regulation 5 and attendant schedules would have to restate permissible caps and investment levels, now unified across asset classes;
      iii. Schedules specifying permitted investments by FIIs, FVCIs and NRIs would ostensibly be replaced by a new schedule for QFIs.
   (b) Depository Participants
      i. Enforcement of contracts between depository participants and investors should be clarified. In particular, international dispute settlement mechanisms should be established;
      ii. SEBI (Depositories and Participants) Regulations, 1996 would have to be amended to allow DPs to set up offshore branches;
      iii. FEMA (Transfer or Issue of Any Foreign Security) Regulations need to be amended to allow setting up of DPs abroad;
      iv. SEBI (Stock Broker and Sub-Broker) Regulations, 1992 would have to be changed to allow stock brokers to register foreign investors as clients with SEBI;
      v. Criteria for filtering DPs who could be entrusted with the task of registering QFIs would have to be promulgated.
   (c) KYC
      i. KYC guidelines for depository participants would have to be adopted and dovetailed with AML-CFT frameworks including those for reporting suspicious transactions ("Suspicious Transaction Reports"). Issues of responsibility for analyzing and taking action on STRs would have to be clarified and responsibilities assigned;
      ii. DPs would report KYC information on behalf of clients investing in unlisted equity directly to the RBI. The RBI, pursuant to Foreign Exchange Management (Deposit) Regulations, 2000, Regulation 5, Schedule 3 would also have to give approval for the opening of limited purpose accounts for securities transactions.
   (d) Miscellaneous
      i. Closely review how and whether regulation tailored to fit specific classes of investors like FVCIs or NBFCs will be included, excluded or modified under the QFI framework
      ii. Scrutinize areas where FDI and capital flows management regulations overlap.
      iii. The language of FEMA (Transfer or Issue of any Foreign Security) Regulations, particularly regulations 6C and 7 would have to be consolidated to address investment by mutual funds and other financial services firms;
      iv. With regard to outflows, the Master Circular on Miscellaneous Remittances from India would have to be modified to permit banks to provide credit facilities to individuals once appropriate consumer protection standards are notified;
      v. Regulations permitting investment in foreign securities, presumably along the lines suggested by IDR policy, would also need to be promulgated.

1.8.3. *Outflows into Equity*

1. All entities structuring and offering securities market-related products in the overseas market, who offer these products to residents on Indian soil, should register with SEBI and fully disclose all promotional materials, including product literature, advertisements and brochures.

1.8.4. *Debt*

1. Remove the caps on rupee-denominated corporate debt as a matter of addressing currency mismatches. Any desired restrictions on debt related capital flows could be expressed in percentage instead of absolute terms;
2. Finish implementing the many recommendations from government committee reports over the past five years that have either partially or not been implemented;
3. Extend the QFI model, our single window for clearance of portfolio investment regulations, to debt investments as well;
4. Extend consumer protection guidelines for investment in foreign securities under the Liberalised Remittance Scheme to investments in debt securities.
5. Legal changes:
   (a) Rescind the limit on FII debt or replace hard caps with percentage limits to remove quantitative restrictions;
   (b) Change SEBI (FII) Regulations, FEMA (Transfer or Issue of Security) Regulations, FEMA (Borrowing and Lending in Rupees) Regulations and SEBI Circular IMD/FII & C/33/2007, October 16, 2008.
   (c) Change FEMA (Transfer or Issue of Any Foreign Security) Regulations, *supra* note 54;
   (d) Change FEMA (Borrowing or Lending in Foreign Exchange Regulations), *supra* note 21;
   (e) Authorize QFIs to invest in security receipts on par with domestic investors; FEMA 20, *supra* note 7, Schedule 5.
   (f) Different treatment of PSU debt and other company debt, FCEB and FCCB could be consolidated into a combined limit.
   (g) Any other legal changes required to implement the package of recommendations compiled by expert committees in recent years.

1.8.5. *Derivatives*

1. Capital flow management regulations should focus on spot instruments and not derivatives;
2. Harmonize the regulation of futures, forwards and options. There should be a general policy preference to encourage greater trade in exchange-traded, as opposed to over-the-counter derivatives;
3. Exempt investment by Indian residents in derivatives trade abroad up to the US $200,000 limit under the Liberalised Remittance Scheme from further regulation. Specifically the ban on taking margin payments should be restated to hold that,when taking margin payments, total liability should not exceed the LRS limit;
4. Streamline registration processes by implementing the QFI model, as suggested above, to also reduce the incentives to participate in offshore markets such as those for participatory notes.

1.8.6. *Tax*

1. Study the revenue implications of shifting to a residence-based system of taxation;
2. Study the information technology systems and information sharing mechanisms with other countries which need to be in place to properly implement taxation of global income of residents in a residence-based taxation system for capital gains. A study of such mechanisms in BSST and OECD countries could be done;
3. Study the administrative issues and short-term revenue implications of shifting from a source-based to a residence-based system with attention to other countries experiences with such transitions;
4. Study the revenue and compliance advantages of source based taxation of capital gains and whether tax and compliance burden would actually reduce if countries followed a source based taxation regime for capital gains.
5. The working group notes that, the Draft Direct Taxes Code, if enacted in its current form, would improve certainty with regard to permanent establishment status for global investors working with fund managers located in India and, as such, would remove this barrier to the development of financial services in the country. The proposal to deem income of FIIs as income from capital gains should be broadened to cover all non-resident investors including private equity funds.
6. Clarify, through a suitable instruction or circular, the circumstances under which a fund manager in India handling the investments of a global fund located abroad would be held to be an "independent agent" and consequently would not constitute a PE in India. Laying down a suitable criteria for "dependent" and "independent" status for fund management services for global investors would help in increasing these services out of India.

CHAPTER 2

Introduction

2.1. Introduction

Expert committees such as the Committee on Fuller Capital Account Convertibility, the Committee on Financial Sector Reforms and the High Powered Expert Committee on Making Mumbai an International Financial Centre have provided broad, overarching views of the role, consequences and timeline for thinking about capital account convertibility in India.[1] This report takes more narrowly drawn steps within the frameworks suggested by those earlier reports.

As such, this group looked at the work of previous government committees and, per our mandate, located the need for reviewing India's foreign investment regime in the difficult climate for financial innovation, the consequent effects on the institutional development of the Indian financial sector and its ability to meet the capital or financing needs of the Indian economy. We examined India's capital flows management laws with the idea of rationalising administrative and institutional barriers to foreign investment while monitoring capital flows and ensuring domestic financial stability. In particular, the working group developed recommendations intended to replicate existing *de facto* arrangements while reducing costs, complexity and legal uncertainty in terms of the law.

The working group considered a few basic ideas in assessing the regulation of capital flows. First, the working group looked at questions related to the rule of law. Specifically, the working group examined the concrete manifestations of principles of accountability, fairness, transparency, certainty and quality of law in the context of specific institutional arrangements and procedural rights like, but not limited to, judicial review and public consultation. Avenues like appellate review with the provision

[1] *See*, Report of the Committee on Fuller Capital Account Convertibility 126 (2006)(The Tarapore Committee, noting that "given the huge investment needs of the country and that domestic savings alone will not be adequate to meet this aim, inflows of foreign capital become imperative. The inflow of foreign equity capital can be in the form of portfolio flows or foreign direct investment (FDI)......." and that while FDI may have a greater impact on growth, the objectives of full capital account convertibility are "(i) to facilitate economic growth through higher investment by minimising the cost of both equity and debt capital; (ii) to improve the efficiency of the financial sector through greater competition thereby minimising intermediation costs and (iii) to provide opportunities for diversification of investments by residents;" *See also*, Committee on Financial Sector Reforms, A Hundred Small Steps 35 (2009) (The Raghuram Rajan Committee, arguing in part that avoiding financial integration may deprive the economy of many of the indirect benefits of financial integration while imposing costs and distortions on the economy); *See also*, The High Powered Expert Committee ("HPEC") on Making Mumbai an International Financial Centre(2007)(Also known as the Percy Mistry Committee).

of reasoned orders and time-bound responses to applications for permissions provide accountability, fairness, transparency and legal certainty along with flexible means of adjusting to new policy circumstances through the incrementalism of individual case adjudication and precedent. Stakeholder participation in the regulatory process, through the channels of public consultation, if properly formulated, can also be a means of deepening the quality and furthering the legitimacy of governance in this specific area of law. In these contexts, the working group also discussed the impact on policy of treating similar investments similarly, of applying the rules of the game consistently to all players, of avoiding categorizing types of players where possible and of basic fairness in government.

The working group then discussed substantive areas of foreign investment law, particularly foreign exchange laws with regard to listed and unlisted equity, debt, which includes the markets for government securities, corporate bonds and external commercial borrowings, and derivatives. As suggested by our mandate, reforms in these areas of law would constitute the key substantive reforms that would address the financing needs of the country's economy. In particular, the working group was interested in closing the gap between de jure norms and de facto practices. Existing policy frameworks for capital flows create a complex, overlapping web of law marked by administrative bottlenecks, contradictory and sometimes duplicate processes. The working group talked about crafting legal classifications with the underlying economic effect of the transaction in mind and discussed in detail discrete policy matters that had a significant impact on recent policy debate, issues like the use of participatory notes and the role of vigorous KYC norms in monitoring capital flows.

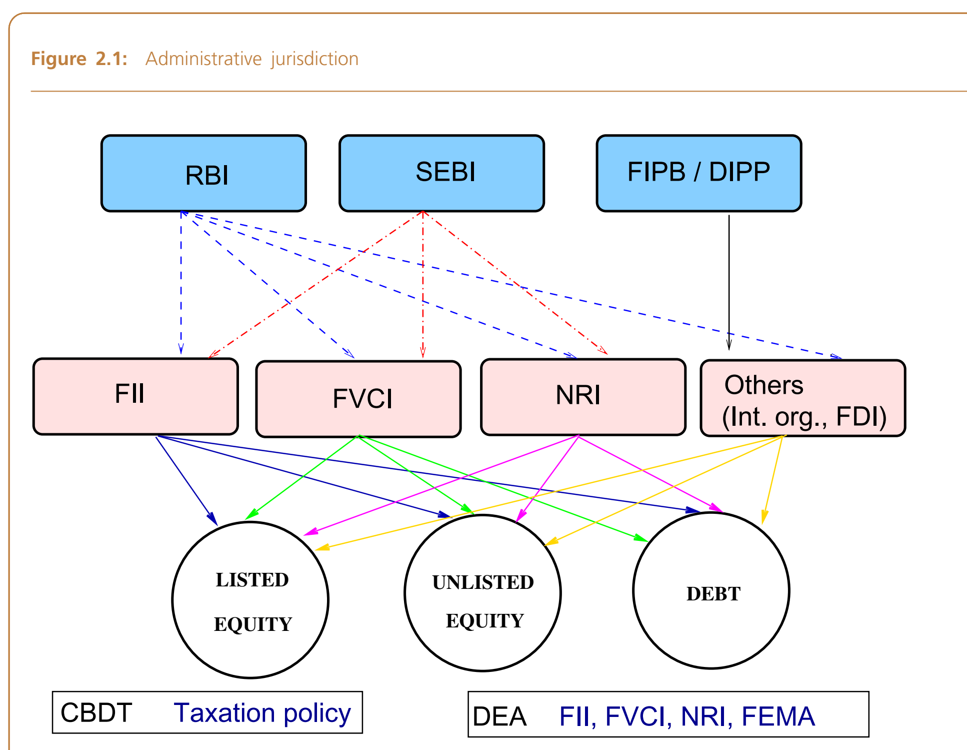
Additionally, the mandate of the working group directed us to examine the taxation of transactions, particularly the rationale of taxation through the Securities Transaction Tax and stamp duty. The group interpreted this charge broadly and looked at the different ways that transactions are taxed in OECD and developing countries. As such, we had conversations about the implications of taxing transactions rather than vehicles, of moving tax policy closer to OECD norms and of understanding that suggesting changes to foreign exchange law without considering concomitant positions in tax law would not provide certainty to investment decisions in the ways desired. The group also thought of the role of tax policy with regard to discussions about supporting the institutional development of domestic financial services.

Comparisons were instructive. The working group looked at the regulation of foreign investment by peer nations. The working group looked most closely at the examples of Brazil, South Africa, South Korea and Turkey, "BSST" nations in our parlance. These countries, both constrained and legitimated by democratic governance, with large internal economies, and roughly comparable levels of political and institutional development, provide perhaps the closest substantive comparator to the policy choices faced by India, though the working group did look at the examples of China, Russia and OECD nations as well.

2.1.1. *Regulatory Framework*

The institutional bodies regulating capital flows include the Reserve Bank of India, the Securities and Exchange Board of India ("SEBI"), the Forward Markets Commission ("FMC"), the Insurance Regulatory and Development Authority ("IRDA"), and the Pension Fund Regulatory and Development Authority ("PFRDA"). Within the Government of India, the Ministry of Finance houses the Department of Revenue, the Department of Economic Affairs ("DEA") and the Department of Financial Services. The Department of Revenue hosts the Central Board of Direct Taxes ("CBDT"). DEA hosts the Capital Markets Division while the Department of Financial Services deals with banks, insurance and pension funds and their respective regulators. The Finance

Figure 2.1: Administrative jurisdiction



Minister heads the Foreign Investment Promotion Board ("FIPB") which approves foreign direct investment, on a case by case basis, into the country. The Ministry of Commerce and Ministry of Finance hosts the Department of Industrial Policy and Promotion ("DIPP") which is responsible for promulgating policy on foreign direct investment into the country.

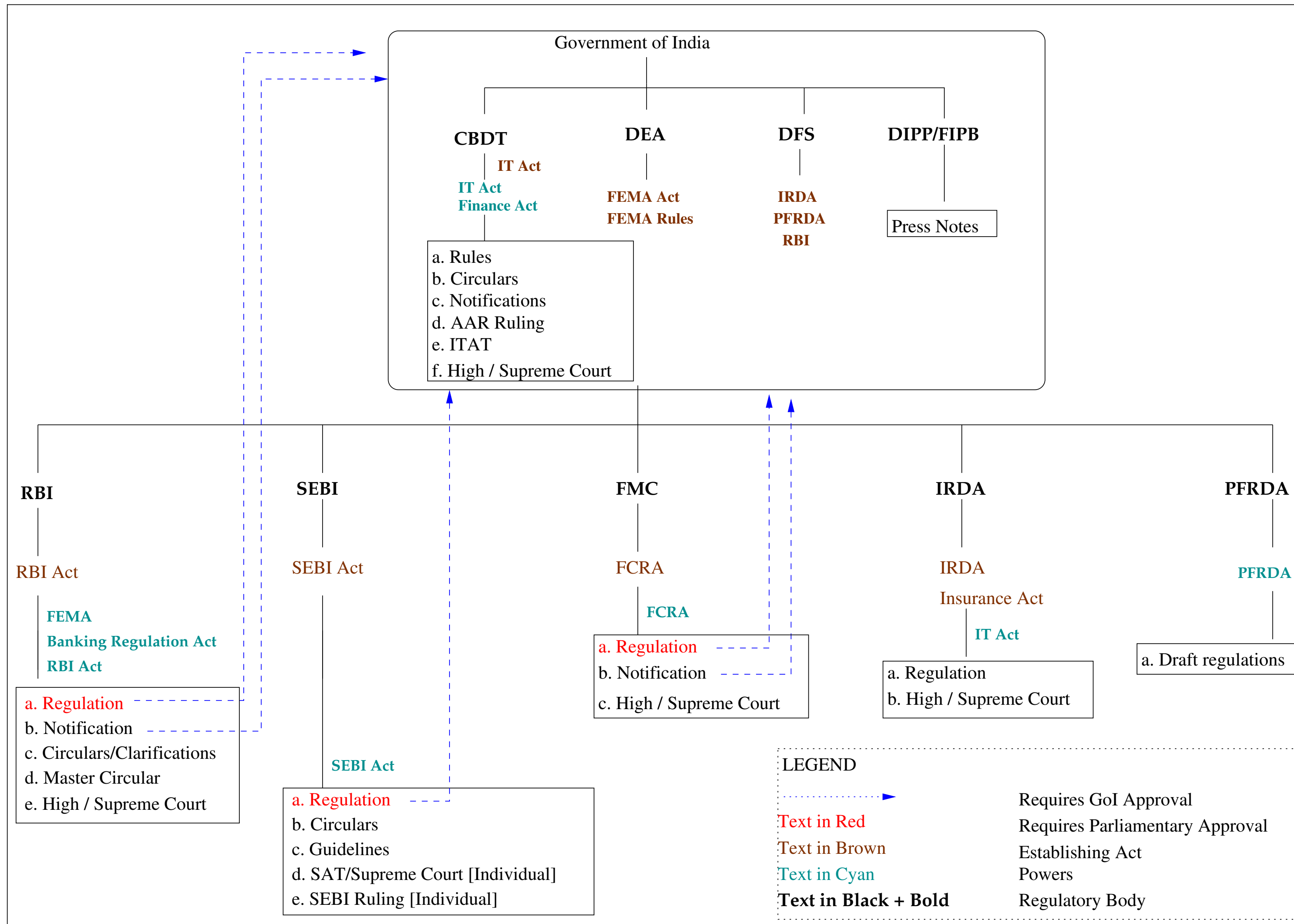
The RBI is given primary authority to regulate capital flows through the Foreign Exchange Management Act ("FEMA"), 1999. Notably, Section 6 of FEMA authorizes the RBI to manage foreign exchange transactions and capital flows in consultation with the Ministry of Finance.[2] The Banking Regulation Act, 1949, and the RBI Act, 1934 also provide the RBI with supporting authority to regulate capital flows. The RBI articulates policy with regard to capital account transactions through regulations, which must be placed before Parliament, notifications, which require publication in the official gazette, circulars and clarifications. The RBI also periodically publishes master circulars, compendiums of all communication by the RBI, on a variety of subjects related to capital flows such as foreign investment, External Commercial Borrowings ("ECB") policy and trade credits. RBI regulation of various financial products is often legitimated by multiple authorizing acts. For example, the RBI regulates derivatives trading on currencies and interest rates under powers given to it through the RBI Amendment Act of 2006,[3] and FEMA.[4]

[2]Foreign Exchange Management Act, 6 (1999)(stating that the Reserve Bank may, in consultation with the Central Government, specify (a) any class or classes of capital account transactions which are permissible; (b) the limit up to which foreign exchange shall be admissible for such transactions, and further granting the RBI the authority to prohibit, restrict or regulate specific forms of financial transactions such as those involving debt, equity, currency and property). Note that the Government has powers under Sections 40 and 41 of FEMA, as well as Sections 16 and 17 of the SEBI Act of 1992, to suspend operations of FEMA and direct the Reserve Bank or SEBI respectively, where the Government considers it necessary or expedient to do so in the public interest. However, these provisions are understood to be emergency provisions not applicable to more routine issues of financial regulation.

[3]Reserve Bank of India (Amendment) Act, (2006).

[4]FEMA (Foreign Exchange Derivative Contracts) Regulations, 2000

Figure 2.2: Organisational Structure of Capital Controls in India



Note: A list of abbreviations can be found at the end of the report.

2.1.2. *Next steps*

Our first substantive chapter provides economic policy analysis that frames the working group's discussions of specific legal regimes and rules governing foreign investment. India has integrated into the world economy more so than ever before, with significant implications for the effectiveness (or not) of monetary and fiscal policy. Our next policy chapter examines issues of legal process. Rule of law is a vast and often amorphous concept that is important to foreign investment and development for intrinsic reasons as well as growth related. The working group looks at rule of law in foreign investment through specific explorations of certain institutional arrangements and procedural rights, in particular judicial review, the role of public consultation, information management and the role of law departments and the seriousness accorded to matters of law. The subsequent four chapters examine the existing regulation of foreign capital flows into listed and unlisted equity markets, corporate and sovereign debt, and derivatives respectively. Our final policy chapter looks at issues of tax policy. Tax policy considerations are integral components of investment decisions. To the extent that the structure of the economy has changed dramatically in recent years, tax policy configured around the assumption that India is, largely, a one-way recipient of capital flows needs further examination. The final chapter begins to do so.

CHAPTER 3

India's internationalisation

From the early 1990s onwards, trade liberalisation in India has been accompanied by a process of gradual liberalisation of capital flows management regulations. The FII framework was setup in the early 1990s, and further rationalised by the late 1990s. The home bias of global equity portfolios against India started getting alleviated by the early 2000s, a decade after the first opening to foreign investors. Debt inflows, and outward flows began in the late 1990s. FDI inflows began in the early 1990s and have gathered momentum, particularly after India became important to global private equity funds.

In this chapter we summarise key empirical facts about India's internationalisation. In order to place these developments in perspective, we compare and contrast India against a group of peer countries. Section 3.1 describes why we chose Brazil, South Africa, South Korea and Turkey, what we call the "BSST nations," as peer countries for comparative purposes. Section 3.2 analyses India's internationalisation as seen through macroeconomic data. Section 3.3 analyses this process as seen through firm level data. Finally, Section 3.4 offers some insights into capital account integration that flow from empirical analysis of the Indian experience from 1992 to 2010.

3.1. India's peers: the BSST countries

From an Indian perspective, comparative policy analysis and proposals are more productive and interesting with BSST countries. We considered two factors in deciding which countries would offer meaningful comparative study: size, and democratic governance with the rule of law.

A certain minimum size should be a pre-requisite for a country to be meaningfully considered a peer to India. States with large internal economies offer similar macroeconomic conditions for analytic purposes. For example, BSST countries are similar with respect to the size of their GDPs, the ratio of consumption to output and the ratio of investment to output. Studies of city states with small domestic economies involve different variables that muddy comparisons. We treat membership of the G-20 as a marker of adequate size.

Governance arrangements in a country are also important when engaged in comparative law or policy comparisons. Of course, the governance arrangements most similar to India, among all G-20 nations, are Brazil, South Africa, South Korea and Turkey.

Table 3.1: Governance Indicators

		Brazil	China	Russia	S Africa	S Korea	Turkey	India
Regulatory Quality	1998	0.3	-0.26	-0.51	0.24	0.33	0.49	-0.39
	2008	0.19	-0.22	-0.56	0.63	0.73	0.22	-0.21
Voice & Accountability	1998	0.19	-1.38	-0.58	0.85	0.62	-0.68	0.32
	2008	0.51	-1.72	-0.97	0.68	0.59	-0.19	0.45
Political Stability	1998	-0.4	-0.09	-0.83	-0.88	0.14	-1.03	-0.87
	2008	-0.12	-0.32	-0.62	-0.04	0.41	-0.73	-0.99
Government Effectiveness	1998	-0.12	-0.3	-0.41	0.95	0.39	-0.17	-0.16
	2008	-0.01	0.24	-0.32	0.75	1.26	0.2	-0.03
Rule of Law	1998	-0.27	-0.36	-0.85	0.14	0.74	-0.08	0.23
	2008	-0.3	-0.33	-0.91	0.12	0.79	0.09	0.12
Corruption	1998	0.1	-0.31	-0.83	0.6	0.21	-0.22	-0.31
	2008	-0.03	-0.44	-0.98	0.3	0.45	0.1	-0.37

Source: World Bank Governance Indicator Database

In recent years, many discussions have centred on BRIC comparisons; comparative analysis of Brazil, Russia, India and China. To us, Russia and China differ sharply from India and Brazil when it comes to issues of governance quality, freedom, democracy, and the rule of law, with attendant implications for policy analysis and proposals. In non-democratic regimes, the policy process and resultant decisions involve different political economy considerations and are likely to substantially differ from the outcomes of a democratic process.

The working group examined the quality of governance in the G-20 countries based on the following indicators[1]:

1. Voice and accountability
2. Political stability
3. Government effectiveness
4. Regulatory quality
5. Rule of law
6. Control of corruption
7. Economic freedom
8. Political freedom

Table 3.1 summarizes our country comparisons using World Bank governance indicators. Governance indicators from the World Bank are measured in units ranging from -2.5 to 2.5, with higher values corresponding to better governance outcomes.

On issues of regulatory quality, India performed as poorly as China or Russia in 2008, but has significantly improved its score since 1998. We feel that India should try to meet the levels of regulatory quality of the BSST nations. Looking at questions of voice and accountability, India's scores fell in the range of values seen for other BSST countries other than Turkey. India's scores on these measures were markedly different from China or Russia. While India's democracy is much celebrated, three of

[1] Kaufmann Daniel et al., World Bank, Governance Matters VIII: Aggregate and Individual Governance Indicators, 1996-2008 (June 29, 2009). World Bank Policy Research Working Paper No. 4978 *available at* http://go.worldbank.org/BWBRP91A50; Legatum Institute, The 2009 Legatum Prosperity Index (1991) *available at* http://www.prosperity.com/downloads/2009LegatumProsperityIndexReport.pdf; Terry Miller et al., *The Heritage foundation, 2010 Index of Economic Freedom, (2010) available at* http://www.heritage.org/index/Download.aspx; Freedom House, *Freedom in the World: Country Reports* (2009) *available at* http://www.freedomhouse.org/template.cfm?page=22&year=2009&country=7550

our peers (Brazil, South Africa and South Korea) were ahead of India in 2008 with regard to providing concrete representation at different levels of government, though India has improved significantly by these measures since 1998.

Looking at matters of political stability, India scored lower than all these peer nations. Examining government effectiveness, India's scores are similar to Brazil and lags the values seen for South Africa, South Korea and Turkey. India has improved the effectiveness of governance since 1998.

India shows comparable scores to South Korea, South Africa and Turkey on questions of rule of law, and again, scores very differently than China or Russia.

Finally, with regard to corruption, India scores better than China or Russia but lags the values seen with BSST countries.

Overall, India is significantly different from China and Russia. India is similar to the BSST countries in some respects and will likely become more so in coming years, extrapolating from past trends. Hence, for the purpose of comparative policy analysis, the committee finds the regulatory approaches adopted by the BSST nations to be suggestive.

3.2. Macroeconomic indicators

While the focus of this report is capital flow management regulations, thinking about the current account is important for this examination given the deep links between current account and capital account integration. In scholarly literature, these two systems typically go together.

On one hand, when firms face competitive pressure on a global scale, they demand the lowest-cost inputs in terms of debt capital, equity capital, risk management and other financial services. On the other hand, increased current account integration results in reduced effectiveness of capital flows management regulations. Finally, countries which more comfortably engage with trade integration would find it easier to move away from autarkic practices with regard to capital account integration.[2]

Table 3.2 shows the level and change in current account integration. India's current account integration rose by 23 percentage points in the 1990s, and an additional 40 percentage points from 2000 to 2008. These *increases* were comparable with those seen with the BSST countries (at 21 and 34 percentage points). At the same time, the *level* of current account integration of India (at 71 percent of GDP) was lower than that seen for the BSST countries where the average stands at 96 percent of GDP.

Turning to capital account integration, we first examine the existing regime of capital flows management regulations, particularly the level of *de jure* capital account openness. Table 3.3 shows information drawn from the work of Menzie Chinn and

[2]In recent years, a small literature has emphasised the two-way links between capital account and current account integration. Wei S.J. and Z. Zhang, *Collateral damage: exchange controls and international trade,* 26, JOURNAL OF INTERNATIONAL MONEY AND FINANCE 5, 841–863 (2007) show that increased capital account restrictions damage international trade in the fashion that increased customs duties do. Aizenman J, *On the hidden links between financial and trade opening,* 27, JOURNAL OF INTERNATIONAL MONEY AND FINANCE 32, 372–386, (2008). Aizenman J. and I. Noy, *FDI and trade – Two-way,* 46,THE QUARTERLY REVIEW OF ECONOMICS AND FINANCE 3, 317–337, (2006) discuss the two-way linkages between current account integration and capital account integration. The misinvoicing literature has long emphasised how taxation and capital flows management regulations can be evaded through international trade. See Patnaik I. *et al.*, *Trade misinvoicing: A channel for de facto capital account openness*, (National Institute of Public Finance and Policy, Technical Report, 2009), *available at* http://www.nipfp.org.in/nipfp-dea-program/PDF/PSS2008_misinvoicing.pdf. Patnaik I. and D. Vasudevan, *Trade misinvoicing and capital flight from India*, JOURNAL OF INTERNATIONAL ECONOMIC STUDIES 99–108 (2000).

Table 3.2: Current account flows to GDP

(Percent to GDP)

Country	1990	2000	2008	Change 1990 to 2000	Change 2000 to 2008
India	8	31	71	23	40
Brazil	23	36	42	13	6
South Africa	39	52	73	13	21
South Korea	61	80	118	19	38
Turkey		81	154		74
BSST average	41	62	96	21	34
China	31	48	64	17	16
Russia		75	65		−10.00

Source: CMIE Business Beacon, IMF International Financial Statistics.

Table 3.3: *De jure* capital account openness: Chinn-Ito measure

Country	1990	2000	2007	Change 1990 to 2000	Change 2000 to 2007
India	−1.13	−1.13	−1.13	0	0
Brazil	−1.81	−1.13	0.99	0.68	2.12
South Africa	−1.81	−1.13	−1.13	0.68	0
South Korea	−0.09	−1.13	0.18	−1.04	0.27
Turkey	−0.09	−1.13	−1.13	−1.04	0
BSST average	−0.95	−1.13	−0.27	−0.18	0.86
China	−1.81	−1.13	−1.13	0.68	0
Russia	–	−1.81	−0.09	–	1.72

Source: Chinn and Ito (2008)

Hiro Ito.[3] Chinn and Ito utilise *AREAER* [4] information on exchange rate arrangements and restrictions supplied by countries to the IMF to provide a provisional assessment of a country's level of openness and integration.

India's score using Chinn-Ito measures of capital account openness stands at -1.13 for all the years examined. This was similar to the BSST average of -0.95 and -1.13 in 1990 and 2000. By 2007, the BSST countries had moved forward to -0.27, which shows much more openness when compared with India. In terms of change, the BSST countries reduced capital account openness by 0.18 in the decade of the 1990s, and opened up by 0.86 from 2000 to 2007. India's change stood at zero throughout.

These results, from the Chinn-Ito dataset and based on the IMF AREAER dataset, seem to contradict the practical sense in India that the country opened up considerably from 1990 to 2007. However, these findings can be reconciled in a few ways:

- Chinn/Ito assessments are based on comparisons. To the extent that the BSST countries have, on aggregate, opened up more thoroughly at a *de jure* level than India, leads to the larger values of openness for them seen under this methodology.
- The sense that India has opened up significantly from 1990 to 2007 is based on

[3] Chinn M.D. and H. Ito. *A new measure of financial openness*, 10, Journal of Comparative Policy Analysis: Research and Practice 3, 309–322, (2008).
[4] International Monetary Fund, Annual Report on Exchange Arrangements and Exchange Restrictions (2006)

Table 3.4: De facto integration: the Gross Investment Position (excluding reserves)

Country				Change	
	1990	2000	2007	1990 to 2000	2000 to 2007
India	30	42	85	12	43
Brazil	40	80	103	40	23
South Africa	52	144	175	92	31
South Korea	34	79	135	45	56
Turkey	35	77	101	42	24
BSST average	40	95	128	55	33
China	38	70	113	32	43
Russia		173	179	–	6

Source: Lane and Milesi-Ferreti (2007)

de facto, as much as *de jure*, openness. Of course, India has liberalized considerably in recent decades, as suggested by the avenues to investment offered by the FII and ECB regimes. Yet, market participants still face a complex system of capital flows management regulations as will be discussed in subsequent chapters. To the extent that economic agents achieve capital account transactions via investments made through complex legal structures, openness is, to some extent, a reflection of *de facto* more so than *de jure* openness. Indeed, this divergence – between *de facto* and *de jure* – is a driving force behind the recommendations of this working group, which are to replicate existing *de facto* arrangements while reducing costs, complexity and legal uncertainty in terms of the law.

The effectiveness of capital flows management regulations are imperfect,[5] and *AREAER* information is only an approximate rendition of the *de facto* capital account openness actually in place. The best measure of capital account integration is the gross investment position of a country. This reflects the foreign assets held by residents and the domestic assets held by foreigners. Assessments of capital account integration are constructed using the database of Philip Lane and Gian Maria Milesi-Ferreti.[6] Official reserves are excluded from this measure in order to focus on the capital account integration of the economy.

Table 3.4 shows that on average, BSST countries had an increase in gross investment position by 55 percentage points in the 1990s followed by a rise of 33 percentage points from 2000 to 2007. The process of India's capital account integration lagged in the 1990s with a rise of only 12 percentage points. From 2000 to 2007, however, the Indian change of 43 percentage points was comparable with the BSST average. In 2007, the Indian level of 85 per cent of GDP significantly lagged the BSST average of 128 per cent of GDP.

While Table 3.4 is the best available measure of the *de facto* capital account integration of a country, two important caveats. First, illegal capital flows are not measured. Second, cross-border derivatives positions and thus contingent claims are excluded. Since these two elements are always positive, the information in the table represents an *understatement* of the true capital account integration.

[5]As an example, see *Controlling capital? Legal restrictions and the asset composition of international financial flows* by Mahir Binicia, Michael Hutchison and Martin Schindler, JOURNAL OF INTERNATIONAL MONEY AND FINANCE 2010 (forthcoming). The authors find that debt and equity flows management regulations can substantially reduce outflows, with little effect on capital inflows, but only high-income countries appear able to effectively impose debt (outflow) management regulations.

[6]Lane P., G.M. Milesi-Ferretti, *The external wealth of nations mark II: Revised and extended estimates of foreign assets and liabilities, 1970-2004*, 73, JOURNAL OF INTERNATIONAL ECONOMICS 2, 223–250, (2007).

Table 3.5: Internationalisation of India's listed firms (by number)

	Percentage of total number of listed companies							
	2001-02				2008-09			
	None	Low	Med.	High	None	Low	Med.	High
Imports	31	32	33	4	25	27	42	7
Exports	62	18	13	8	52	21	16	10
Foreign equity	35	9	4	1	31	13	8	3
Foreign borrowing	91	4	4	1	81	5	10	4
Overseas assets	93	6	1	0.1	83	12	3	1

Source: CMIE Prowess database.

3.3. Internationalisation of firms

As India has opened the economy, firms have increasingly internationalised. Five dimensions of internationalisation are significant:

1. A firm could import, thus buying raw materials and/or capital goods from foreign providers;
2. A firm could export;
3. A firm could obtain equity capital from external sources;
4. A firm could obtain debt capital from external sources (whether local-currency denominated or foreign-currency denominated);
5. A firm could expand overseas, thus placing foreign assets on its balance sheet.

Different firms might reflect different levels of participation in these five modes of internationalisation.[7] In order to describe the extent of internationalisation of Indian firms, we define four categories: none, low, medium and high.

So, for example, a firm exporting between zero and ten percent of its goods would be placed in the "Low" category for this variable. A firm that obtains above 50 percent of its debt capital from external sources would be classified as "High" for that variable, while those between 10 and 50 percent would be described as "Medium."

Using information from the CMIE database, we classify all firms into one of these four categories in all the four dimensions.[8] Table 3.5 shows the number of firms in each of the four categories, comparing 2001-02 against 2008-09.

With imports, in 2001-02, 31 percent of the firms did not import and 32 percent were importing in the "Low" category. Within seven years, these values had dropped to 25 and 27 per cent respectively, "High" importing firms increased from 4 per cent to 7 per cent over this period. Almost half of firms were in either "Medium" or "High" imports.

The highest fraction of firms in the High category in 2008-09 is seen with exports, at 10 per cent. At the same time, the median firm does not export; 52 percent of firms are at zero exports.

Foreign equity ownership is not widespread amongst Indian firms, reflecting the 'home bias' of foreign investors that is shaped by a combination of distance, asymmetric information and India's capital flow management regulations. While 91 per cent

[7] See Pradhan P., *Growth of Indian Multinationals in the World Economy*, (Institute for Studies in Industrial Development, Working Paper No. 2007/04, 2007) *available at* http://www.isid.org.in/pdf/WP0704.pdf. For an integrated treatment of the exporting status and outbound FDI status of Indian firms, see Demirbas D. *et al.*, *Graduating to Globalisation: A Study of Southern Multinationals*, (National Institute of Public Finance and Policy, Working Paper No. 64, 2010), *available at* http://nipfp.blogspot.com/2010/02/graduating-to-globalisation-study-of.html.

[8] In 2001-02, there were 6,575 listed firms in India and in 2007-08 there were 6,268 listed firms.

Table 3.6: Internationalisation of India's listed firms (by size)

Percentage of total mass of all listed companies

	2001-02				2008-09			
	None	Low	Med.	High	None	Low	Med.	High
Imports	5.31	30.70	48.26	15.71	5.99	27.53	51.45	15.01
Exports	56.63	28.33	11.39	3.63	53.84	26.12	11.83	8.21
Foreign equity	22.27	37.33	36.72	3.66	3.70	33.99	56.56	5.74
Foreign borrowing	46.39	14.63	23.66	15.31	25.63	20.14	33.47	20.74
Overseas assets	60.29	39.04	0.45	0.21	43.49	50.00	5.17	1.32

Source: CMIE Prowess database.

of firms had zero foreign investment in 2001-02, this number dropped slightly to 81 per cent in 2008-09. While 5 per cent of the firms were in either Medium or High categories in 2001-02, this rose to 14 per cent in 2008-09.

With foreign borrowing, 5 per cent of firms were in either Medium or High categories in 2001-02. This rose to 15 per cent in 2008-09.

The last dimension of internationalisation lies in Indian firms placing overseas assets on their balance sheet. Holdings of overseas assets were practically non-existent in 2001-02, with 1.1 per cent of firms falling into either Medium or High categories. Holdings of overseas firms had risen to 4 percent in 2008-09.

Table 3.6 approaches internationalisation of Indian firms by reporting the fraction of aggregate or total firms size in each category. For our purposes, size is defined as the average of firm sales and total assets. When compared with Table 3.5, the results reflect the greater activity of larger firms.

In 2001-02, 64 percent of total firms size involved corporations importing in the Medium or High categories. By 2008-09, this had risen to 66 per cent, a rise of 2 per cent. With exports, in 2001-02, 15 per cent of this mass was in either Medium or High categories. By 2008-09, the total firm size involved corporates exporting in the Medium-High categories had risen to 20 per cent, a rise of 5 per cent. With both trade-based measures, the change in international economic integration over this period was small.

In 2001-02, 40 per cent of the mass of Indian firms had either Medium or High equity investment. By 2008-09, this stood at 62 per cent: a sharp rise of 22 percentage points. While foreign equity investment has percolated into a small *number* of firms, their importance in the economy is considerable.

With foreign borrowing, in 2001-02, only 5 per cent of the firms were in either Medium or High categories. Yet these firms accounted for 39 per cent of the mass in the economy. In 2008-09, while the fraction of firms borrowing abroad had gone up to 15 per cent based on numbers, 54 percent of total firms size involved corporations borrowing over 10 percent of their needs abroad.

Finally, with overseas assets, less than 1 per cent of Indian firms had either Medium or High overseas assets in 2001-02. By 2008-09, the number of Indian firms with Medium or High overseas asset had risen sharply to 6 per cent.

3.4. The behaviour of the Indian economy

In this section, we briefly assess some questions about the behaviour of the Indian macroeconomy and Indian firms given India's deepening de facto capital account integration.

Table 3.7: Do FIIs exit *en masse* at times of domestic stress?

	Net FII flows (Rs. Crores)			Percent to mkt. capn.		
Event	T-1	T	T+1	T-1	T	T+1
Parliament attack 12-12-2001	−91.0	78.8	−90.4	−0.015	0.012	−0.015
Gujarat riots 27-02-2002	141.8	178.8	−2.9	0.020	0.025	−0.0001
UPA government 13-05-2004	−295.1	−604.4	−504.4	−0.029	−0.060	−0.050
Mumbai attacks 26-11-2008	−436.0	holiday	419.4	−0.015	NA	0.015

Source: CMIE Business Beacon database.

Table 3.8: Gross versus net FII activity in the crisis

(Rs. crores)

Month	Gross buy	Gross sell	Net buy
July 2008	70592	68010	2582
August 2008	48914	49792	-877
September 2008	75214	80061	-4846
October 2008	52014	68310	-16296
November 2008	37746	36383	1363
December 2008	38925	36979	1945

Source: CMIE Business Beacon

3.4.1. *Concerns about reversal*

A major impetus behind India's reluctant capital account liberalisation is a fear of an *en masse* exit by foreign investors from the Indian economy. In 1992, when capital account liberalisation was first undertaken, there was no Indian evidence to assess the significance of such behaviour. By 2010, however, a considerable body of empirical data exists to investigate, contextualise and address these concerns.

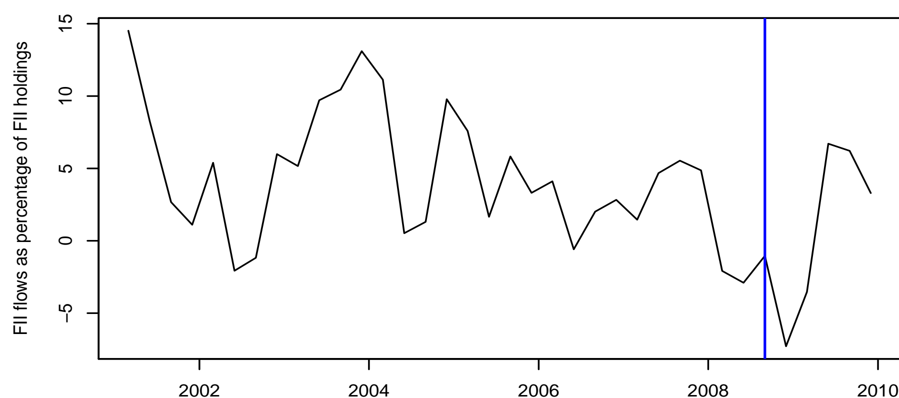
3.4.1.1. *Are FIIs fair weather friends?*

Looking at *en masse* exit by FIIs in times of domestic stress, Table 3.7 shows information about net FII inflows on the equity market in four recent episodes of market stress. In each of them, relatively small values are seen for the net sales by FIIs. The largest values in the table involve net sales of 0.11 percent of market capitalisation on the event date ('T') and the following day ('T+1') associated with the formation of the UPA government in 2004. The scenario of massive sales by foreigners when India is experiencing difficulties does not fit the evidence we examined.

3.4.1.2. *Behaviour of FIIs in the Lehman crisis*

Table 3.8 shows data for FII activity in the crisis. The biggest exit in this data was in October 2008, of Rs.16,296 crores of equity capital. However, in October 2008 FIIs (as a whole) *purchased* Rs.52,104 crores of shares and sold Rs.68,310 crores. We note that many thousands of foreign investors are now operating in India, with a diversity of views between them. On any given day, some FIIs buy and other FIIs sell. There is little evidence of *en masse* exit, where a large fraction of FIIs move in only one direction.

Figure 3.1: Net equity inflow/outflow expressed as per cent of foreign equity ownership



Source: CMIE Prowess

3.4.1.3. *Evidence from BOP data for large exits*

Figure 3.1 shows the net equity inflow or outflow for each quarter, expressed as a percent of the value of the aggregate foreign equity portfolio present at the start of the quarter.[9] The worst exit by foreign investors was seen after the Lehman crisis of September 2008 (marked with a vertical line). In the October-November-December 2008 quarter, exits by foreigners amounted to 6 per cent of their holdings on 30th September 2008. As such, we feel that while the scenario of a large exit by foreign investors can be envisaged, the practical significance of such a scenario is relatively limited.

3.4.1.4. *Contagion from Satyam?*

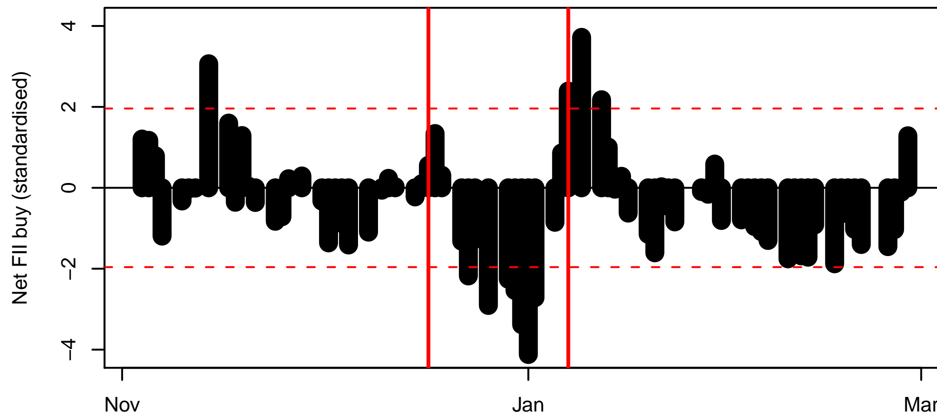
The revelation of corporate governance fraud and accounting fraud by Satyam Computer Services in December 2008 and then in January 2009, another major crisis point for Indian capitalism, also offers further insights into *en masse* exit by foreign investors can be obtained. When accounting fraud was disclosed by Satyam foreign investors did not appear to generalise from these events to India at large. There was no large-scale exit by foreign investors from India.

Figure 3.2 shows the daily time-series of the net purchase by all foreign investors on the equity market, for securities *other* than Satyam.[10] The time-series is expressed in units of standard deviations. The two vertical lines are the two dates of announcements of fraud. In the days that followed each announcement, there was net selling by FIIs for securities *other* than Satyam. However, the magnitudes were relatively small, with only a few days (at the end of December 2008) exceeding two standard deviations. On the date of announcement of the fraud in January 2009, and on the date after it, FIIs were net *purchasers* of firms other than Satyam, reflecting a

[9] The value of the foreign equity portfolio at the start of each quarter is computed by summing up foreign holdings in all firms as seen in the CMIE database.

[10] Shah Ajay and I. Patnaik, Securities Markets and Foreign Investors in the Aftermath of a Corporate Scandal: Evidence from the Satyam Episode (2010) (unpublished manuscript, on file with National Institute of Public Finance and Policy).

Figure 3.2: Buy/sell by all FIIs in shares of firms other than Satyam



Source: SEBI

Table 3.9: Exchange rate flexibility and the currency risk of firms

Period	INR/USD volatility	Average currency risk of firms
1 April 1993 to 17 February 1995	0.16	5.899
17 February 1995 to 21 August 1998	0.93	0.540
21 August 1998 to 19 March 2004	0.29	3.753
19 March 2004 to 31 March 2008	0.64	2.066

re-allocation from Satyam to other Indian software companies while preserving the industry weights of the overall portfolio.

3.4.2. *Macroeconomic dimensions of internationalisation*

3.4.2.1. *Does the currency risk of firms respond to changes in exchange rate flexibility?*

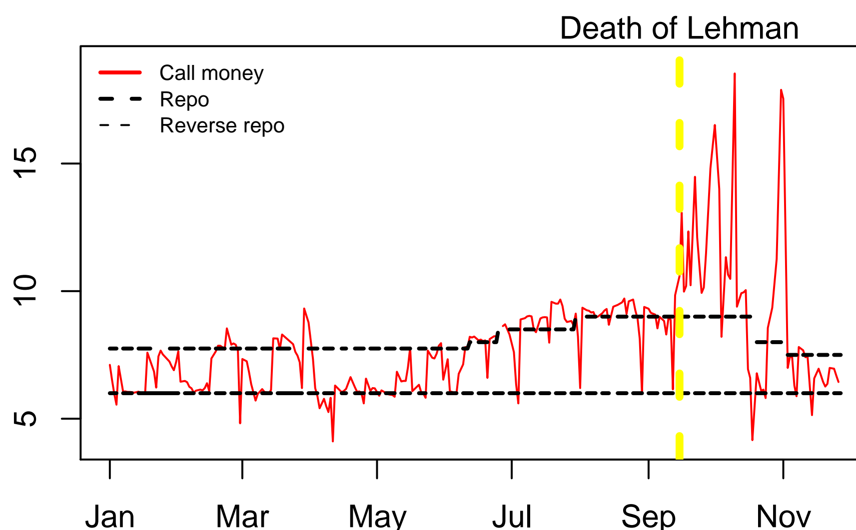
Currency expectations of firms and their currency exposure offer two alternative perspectives on the macroeconomic dimensions of internationalisation.

One view involves thinking that India is mostly closed and that firms are relatively unsophisticated about addressing exchange rate risk. In this case firm exposure should be largely stable across changes in the exchange rate regime.

An alternative view involves thinking that India is substantially open, and that the firms are quite concerned about exchange rate risk. In this case moral hazard should be visible across changes in the exchange rate regime. Firms should have more exchange rate exposure when there is reduced exchange rate volatility, and vice versa.

Table 3.9 shows the analysis of how the currency exposure of large Indian firms

Figure 3.3: Monetary policy operating procedure under stress



varied across changes in the exchange rate regime.[11]

The economic history of the Indian exchange rate regime is broken into four periods where exchange rate volatility was, in turn, low, high, low and then high. The currency risk of the firms[12] shows the opposite pattern: high, low, high and then low.

These findings suggest that when the central bank has an exchange rate regime with reduced exchange rate flexibility, and a country's capital account is sufficiently open, firms are alert and able to modify their currency risk to exploit opportunities presented to these firms. Indian multinationals handling of currency risk patterns then suggest relative agility in managing changes in the exchange rate.

3.4.2.2. *Why did the Indian money market face difficulties after the bankruptcy of Lehman Brothers?*

The Lehman default of September 2008 also reflects similar stories about India's existing level of integration and responsiveness to global macroeconomic fluctuations. If India were largely closed, then the global turmoil in the money market would not have influenced India, a reasonable proposition given the restrictions on the overseas money market financing before September 2008.

Figure 3.3 shows the fluctuations of the call money rate, juxtaposed against the repo and the reverse repo rate. Under ordinary circumstances, the operating procedures of monetary policy were configured to ensure that the call money rate stayed between the repo and the reverse repo rate. However, when the Lehman bankruptcy took place, the operating procedures of monetary policy came under stress. Monetary policy was unable to ensure that the call money rate stayed within this band. The call money rate went well beyond the repo and the reverse repo rate.

If India were mostly a closed economy, such behaviour would not have taken place. Banks and firms operating in a relatively closed environment would osten-

[11] Patnaik I and Shah A., *Does the Currency Regime Shape Unhedged Currency Exposure?*, Journal of International Money and Finance(2010).

[12] We look at the top 100 firms of India, the members of Nifty and Nifty Junior.

sibly be expected to be unaffected by crises like these. Ila Patnaik and Ajay Shah offer evidence that Indian multinationals played an important part in these events.[13] Multinationals operating global treasuries were a conduit between global events and domestic money markets. We suggested in Section 3.3 that firms accounting for 56.51 percent of the mass of Indian companies had outbound FDI. This rise of Indian multinationals has important implications for the extent of India's integration: it suggests that India has achieved significant *de facto* openness.

[13]Patnaik Ila and A. Shah, Why India Choked When Lehman Broke, India Policy Forum (2009).

CHAPTER 4

Legal Process

Legal process and rule of law concerns figured prominently in the working group's deliberations and constitute some of the most important recommendations of this report. Rule of law is of vital importance in it's own right, and as a matter of promoting foreign investment and development. The first section of this chapter lays out first principles. What do we mean by rule of law? Why is it important?

While most of the legal policy sections of this report focus on rationalizing the substance of foreign exchange regulation, this section focuses on rationalizing the *process* of such regulation. Regulation of capital flows have typically been seen as an instrument of monetary policy. Administrative decisions involving the application of capital flows management regulations to individual market participants have been granted the autonomy accorded to larger monetary policy decisions such as Reserve Bank setting of the short term interest rate. To the extent that the application of foreign exchange law affects the ability and extent of individual actors to participate in markets, these rules are a significant part of financial sector regulation. As such, the best practices and basic principles of rule of law that apply to other areas of regulation, should apply to these matters as well. To, for example, meet broad policy objectives through denial of registration, licenses and other permissions leads to effective discrimination between similarly placed actors with regard to important economic opportunities.

The subsequent sections of this chapter pick up discrete yet quite significant manifestations of rule of law concerns that figure tremendously in the legitimacy and quality of India's foreign investment law. These sections examine, in turn, issues of judicial review, public consultation, information management and the role of law departments. Each section provides our assessment of current institutional arrangements, processes and legal guarantees, followed by our recommendations. For reasons of focus, the working group directed its attention to the regulatory processes offered by the RBI and SEBI, the two most prominent regulators of foreign investment though certainly these principles could be extended to analyses of the functioning of other financial sector regulators. The rule of law is a vast, complex and often amorphous subject that extends to many more subjects than foreign exchange laws. In this section, we hope to present concrete indicators of the extent to which India has been able to materially realize, in the realm of financial sector regulation and foreign investment law, certain core principles of democracy and good governance.

4.1. Principles: What is legal process and why is it important?

The concept of rule of law is a core principle of governance with deep roots in Eastern and Western philosophical and legal traditions.[1] While subject to a diverse range of interpretations, rule of law could be understood simply as the notion of holding government authority to account and placing the wishes of the populace before the rulers. Legal process too, could be subject to diverse interpretations, though the working group uses the term to refer broadly to the processes, procedural rights and institutions through which law is applied. The working group notes that the processes, procedural rights and institutions suggested by the term "legal process" are one concrete manifestation of India's commitment to rule of law.

The rule of law is important in its own right, for reasons of the inherent legitimacy of governance as well as, more narrowly, economic growth and development. Important values, inherently a part of rule of law include, but are not limited to, principles of transparency and legal certainty, accountability, fairness in application and equality before the law. These values also include supremacy of law (as opposed to arbitrary acts of man), separation of powers and participation in decision-making.[2] Rule of law also furthers growth and development through promotion of market integrity and confidence in foreign investors of the soundness of India's markets and the protection of property rights. In complex societies, government decisions confer largesse–government decisions to grant licenses, permissions and registration, for example, effectively confer financial benefits–and should not be awarded or withheld for arbitrary reasons.

4.2. Judicial review: Accountability, fairness and participation

4.2.1. *Current arrangements*

Judicial review is an important part of rule of law for reasons of accountability, fairness and participation. Judicial review creates accountability and ensures fairness. In the context of administrative agency decisions and financial regulation, judicial review requires a regulator to defend it's actions in light of the law. Discretionary acts of judgement are assessed in the context of specific legal mandates, the letter of a law (here typically regulation) and not arbitrary whim.[3] The provision of reasoned orders, typically an integral part of judicial review, also provides concrete guidance as to the state of the law while allowing regulatory bodies the flexibility to adjusting to changing policy circumstances through the incrementalism afforded by individual case adjudication and precedent. Reasoned orders provide specific direction as to the interpretation of a legal clause, directive, notification or other legal instrument in a particular context, that, when combined with principles of precedent, norms the actions of regulators and market participants and ensures fairness in markets.

[1] What is the rule of law, UN Rule of Law, *available at* http://www.unrol.org/article.aspx?article_id=3 (Tracing the roots of rule of law to the Code of Hammurabi in 1760 BC, the Confucian tradition and the Magna Carta in 1215, amongst other examples.) In India, the Ashokan Edicts articulate principles of fairness and uniformity of law. *See*, The Edicts of Asoka, The Seven Pillar Edicts, *available at* http://www.cs.colostate.edu/~malaiya/ashoka.html (Edict No. 4). The Constitution of India, in turn, lays down many safeguards against arbitrary state action. Article 14 of the Constitution guarantees equal treatment of the law to all persons in the territory of India. Article 21 guarantees rights to due process. *See*, Maneka Gandhi v. Union of India, AIR 1978 SC 597, 1978 SCR (2) 621 (recognizing the rule of law as an essential feature of Indian constitutional law.)

[2] UN Rule of Law, *supra* note 1.

[3] Committee on Financial Sector Reforms, A Hundred Small Steps 133 (2009) [hereinafter, Committee on Financial Sector Reforms]. The Rajan Committee states that appellate review is particularly important the greater the discretionary powers enjoyed by an agency.

Judicial review also allows participation and thereby greater discipline in the creation of regulations, notifications or other law. While judges are not elected and legal processes expensive, courts allow participation in decision-making processes by a much larger class of people than is typically the case with parliamentary or agency decision-making. For all the limitations of the court process in India, legal persons can reasonably anticipate being heard in ways that is hardly guaranteed in other arenas of government.

Regulation involves two levels of action: policy formulation and execution.[4] Judicial review of policy formulation is limited and involves courts examining whether an agency's expression of policy violates any grant of authority under governing law. Judicial review of policy execution, however, is broader and deeper. Judicial review is broader because the range of issues that must be considered is extensive. For example, courts look at issues of conflict of interest and proportionality as well as whether principles of natural justice, such as issuances of notices and fair hearing of parties, were followed. Judicial review of policy execution is deeper to the extent of court's involvement in the protection of rights and obligations. For example, courts look for arbitrariness, bias, corruption, and generally reasons for denial.

How do the RBI and SEBI fare with regard to the provision of accountability, transparency and participation, at least in the context of judicial review? Typically, RBI regulation of capital flows has been seen purely as an act of monetary policy under the discretion of the central bank and not a regulatory action worthy of legal appeals. Viewed from the perspective of individual regulated parties, denial of registration, licenses and other permissions severely restrict the scope of entities participation in markets. Policy decisions should not be implemented in an ad hoc manner and in ways targeted at individual participants.

The working group believes, generally speaking, that policy decisions should affect all parties uniformly. Decisions such as registration, licenses and other permissions affect individual entities. While there will be some unavoidable relationship between policy formulation and execution, the standard of judicial review for these two categories of action are different in other areas of law and should be different with regard to foreign investment law as well. While regulators should have the freedom to formulate policies specified in the law, applying policies to individual entities must be consistent, uniform, and transparent.[5]

Currently, for violations of FEMA, administrative hearings are provided by first, "adjudication officers" and second, "Special Directors (Appeals)" who are appointed by, and are a part of, the Central Government. Appeals from such decisions are to a tribunal created by the Central Government under the act. The FEMA tribunal is permitted to review decisions regarding violations of the Act or any rule, regulation, notification, direction, order or condition of an authorisation.[6] The tribunal is staffed by the Directorate of Enforcement with revenue officers on deputation. The tribunal cannot hear appeals against decisions taken by RBI regarding regulatory approvals.

[4]As we use the terms, SEBI (FII) Regulations are an example of policy formulation. The granting or denial of a single FII registration is policy execution.

[5]Members commented that regulators in India often have rules which are applied as matter of practice, although not documented in a formal rule or regulation. Often these are not applied consistently; licenses issued by SEBI to FVCIs and FIIs often come with conditions which keep changing. In particular, members noted that venture capital fund licences have been issued in the past with the condition that the venture capital fund cannot invest in foreign securities. Sometimes this condition was not included in the license itself, but a separate letter was issued to domestic custodian, sometimes no such condition was imposed, all this when venture capital regulations specifically permit a venture capital fund to make investments in offshore companies which have an India connection up to a specified limit. What constitutes an "Indian connection" is not specifically defined. Members also noted that Indian regulation could be better served by more frequent issuances of "mission statements" or "business plans" like the RBI's Annual Policy Statement.

[6]Foreign Exchange Management Act §§13-35 (1999)[hereinafter *FEMA*].

Box 4.1: Legal process available where registration is not granted by SEBI

When appellate procedures are not specified in full detail, as is the case for certain classes of investors, particularly in situations involving delays in granting or rejecting applications, applicants are forced to seek remedies from constitutional writ courts, which do not have specialized expertise in financial sector regulation, and which can then lead to delays in the investment process.

For FIIs, the SEBI Act offers different appeals procedures for appeals against decisions involving different institutional actors. When SEBI decides to reject an application by a hopeful FII, the Board is required to so after giving an opportunity to the applicant to be heard. SEBI regulations require that rejection of applications be accompanied with reasons for that rejection. After such a rejection the applicant also has the right to apply to the Board (of SEBI) for re-consideration. However, there is no fixed timeline within which the application must be granted or rejected. Potentially, the regulator could sit on applications for an indefinite period of time and since no order has been passed, provisions for appeal cannot be invoked. One additional limiting factor, from legal process perspectives, is that the reviewing authority is the same as the original authority.(*See*, SEBI (Foreign Institutional Investors) Regulations, 1995, *at* Regulation 11) SEBI publishes the reasoned order when denying permissions on its website. (*See*, Order in the matter of First Global (UK) Ltd, dated March 04, 2010 *available at* http://www.sebi.gov.in/Index.jsp?contentDisp=Section&sec_id=2). Such orders are appealable to the Securities Appellate Tribunal.

In the case of sub-accounts, SEBI is not required by regulation to provide a procedure for reconsideration of applications of sub-accounts. (SEBI (Foreign Institutional Investors) Regulations, 1995, *at* Regulation 13.)

For Foreign Venture Capital Investor registration applications, SEBI is under the obligation to give the applicant a hearing before the application is rejected. However, to the extent that there is no specified period within which an application is rejected or accepted, a party facing delays in receiving a decision on a given application would have no order to appeal to the SAT and would have to approach a constitutional writ court seeking a direction requiring SEBI to consider the application in a timely fashion. Also unlike FII registrations, where there is a clear requirement for providing reasons for rejection of a registration application in regulations, there is no explicit requirement for SEBI to give any reasons for rejection of foreign venture capital applications though normally reasons would have to be provided under accepted principles of natural justice under Indian law. There is also no procedure for application for reconsideration available.(SEBI (Foreign Venture Capital Investors) Regulations, 2000 *at* Regulation 9).

For domestic registrations, the provision for review of permissions or registrations are not unified or harmonized. For example, the procedure for rejection of an application to register as a stock-broker is similar to that of a rejection of an FII registration.(*See*, SEBI (Stock Broker & Sub-Broker) Regulations, 1992, *at* Regulation 8 and Regulation 13 for Sub-Brokers) However, SEBI, as per regulation, is not required to provide applicants for registration as a mutual fund hearings, reasons for rejections or any procedure for appeals or reconsideration of applications.(*See*, SEBI (Mutual Funds) Regulations, 1996 *at* Regulation 11).

Orders are also not part of the public domain therefore limiting the development of case law and jurisprudence on these matters. A person aggrieved by a decision or order of the appellate tribunal created by the Central Government must file an appeal to the appropriate High Court.[7] Foreigners are treated no differently than domestic participants in that neither have rights to judicial review of regulatory approvals.

In contrast, every order passed by SEBI in connection with a violation of the SEBI Act, or rules or regulations made under the SEBI Act, is appealable before the Securities Appellate Tribunal as a matter of statutory right.[8] Decisions to deny registration must be made in writing.[9] Institutions and individuals may appeal denial of registration.[10] Note also, that there is no specialized tribunal to hear appeals of matters involving PFRDA, IRDA and FMC though language in draft bills would have

[7] *Id.*

[8] Securities and Exchange Board of India Act, 1992 §15T (allowing appeals of all orders made by an adjudicating officer under this act); Securities Contract Regulation Act, 1956, §23L.

[9] SEBI (Foreign Institutional Investors) Regulations, 1995, §11.

[10] *Id.*

Box 4.2: Legal process available where permission is not granted by FIPB and the RBI

The FIPB is constituted as an executive committee and assesses matters on a case by case basis. FIPB is also part of the executive branch and not an independent regulator with significant investigative capabilities. As such, the FIPB is limited to asking for more information in cases where applications raise suspicions with regards to intent and denying those applications that fail to provide adequate and satisfactory information. In this context, when the FIPB grants and publishes permissions, the board does not provide reasons, but lists the commercial details in press releases.(*See,* FIPB application status *available at* http://finmin.nic.in/fipbweb/fipbwebreports/casesarchive.asp) When proposals are rejected, FIPB often does not articulate reasons for such rejection. Although all executive decisions are challengeable in a constitutional writ court, the standard of review is very different from an appeal to a specialized tribunal like the Securities Appellate Tribunal. Public provision of reasoned responses build a body of principles around which decisions are made (case law) that future applicants can rely on to develop a more nuanced sense of the law. The working group considers whether allowing withdrawal of cases that raise suspicions relating to the law and publishing decisions that proceed further, or to state matters differently formalizing the FIPB review process, is not incompatible.

Looking at the handling of permissions under FEMA by the RBI, no formal system of appealing permissions currently exists. There is no time limit within which a permission may be granted or denied, and no related obligation to provide reasons for the denial of a permission.(*See*, FEM(Transfer or Issue of Security by a Person Resident Outside India) Regulations, 2000 at Schedule 6, Paragraph 1) Decisions regarding permissions are not published by RBI. Often, applicants are provided no clear indication of when permissions would be given. A list of pending permissions is available on the SEBI website; some permissions have been pending for more than five years. However, such tracking mechanisms are not universal with regulators. (*See*, http://www.sebi.gov.in/pmd/fvci-status.html Site last visited 24th May, 2010). The working group's intention is hardly to suggest any mala fide intent. Rather, the working group draws attention to those areas where less than fully developed legal process guarantees leads to inadequate signals being given to market participants about the operation of the law.

authorized SAT to hear appeals against orders made by all three of these agencies.[11]

4.2.2. *Recommendations: Appellate tribunal*

As with the Raghuram Rajan Committee, this working group recommends the creation of a financial sector appellate tribunal, or initially the extension of authority of the Securities Appellate Tribunal to hear appeals against regulatory decisions made by PFRDA, IRDA, SEBI, RBI & FMC.[12] This process should ostensibly include first and second levels of administrative appeals, as well as the provision for awarding remedies.[13] As with Securities Appellate Tribunal appeals, appeals from the FSAT would go directly to the Supreme Court, bypassing the High Courts, though writ jurisdiction of the High Courts would not be completely precluded. Registrations, licenses and other permissions create or allow important economic opportunities for regulated entities. Denials of such should be done with transparency and explicit reasoning. Further-

[11] Pension Fund Regulatory and Development Authority Bill, Bill No. 36 of 2005,(Lok Sabha) §33 (The draft PFRDA bill authorized SAT to hear appeals against orders made by the agency, though this bill has lapsed); *See*, Insurance Laws (Amendment) Bill, Bill No. 72 of 2008, (Rajya Sabha) §98; *See*, STANDING COMMITTEE ON FOOD, CONSUMER AFFAIRS AND PUBLIC DISTRIBUTION, SEVENTEENTH REPORT. FORWARD CONTRACTS (REGULATION) AMENDMENT BILL, 2006 §F (Stating that one of the main objectives of the bill was to make provisions for appeals of orders from the FMC to the SAT).

[12] *See*, Committee on Financial Sector Reforms, *supra*, note 3 at 133. For example, the Monetary Authority of Singapore ("MAS") has formal consultations which involve issuing a consultation paper, followed by issuance of a paper setting out responses to the feedback it has received. The response paper issued by MAS details industry concerns and MAS responses and final view. In doing so, the Authority provides some indication of the shape of regulations and amendments being formulated.

[13] *See generally,* Administrative Tribunals Act 1985, Act 13 of 1985, Armed Forces Tribunal Act 2007. The current practice of the judicial system is to require two administrative appeals before the writ jurisdiction of the courts are exercised.

more, agencies should not attempt to meet broad policy objectives through denial of these permissions.

If a regulation prescribes particular criteria and that criteria is not applied, a right to appeal should follow. The new tribunal would also provide reasoned responses for decisions involving interpretations of law. Writing reasoned opinions provides guidance to stakeholders and the public about the state of the law in a given area. Such decisions should also be published. Publication of decisions leads to the creation of a body of reasoning over time that both reduces regulatory uncertainty and allows the law to adapt to new issues and phenomena as they arise. Foreign investors should be afforded the same process as domestic investors.

The working group notes extension of authority of the SAT can be taken as a practical first step to institutionalize appellate review. The existing court system is overwhelmed and mainline judges have neither the time nor specialized expertise to focus specifically on matters of financial law. As noted above, creating a new financial tribunal through parliamentary approval would be quite time-consuming. The Securities Appellate Tribunal has over a decade of experience hearing disputes involving securities matters. The working group notes that judicial review is not a cure-all solution and that courts are often deferential to agency policy preferences.[14] Yet, creating or extending the infrastructure for appellate legal process will offer concrete means for market participants and the public to more fully realize values of accountability, fairness and participation.[15] The working group emphasizes that introduction of an appellate process for regulatory decisions of administration of FEMA and capital flows management regulations made under FEMA should be a high priority for the government.

4.3. Public consultation: Participation and quality of law

4.3.1. *Current arrangements*

Consultation is important for reasons of participation, accountability, transparency and quality of law. Participation benefits stakeholders by giving them some voice in decision-making processes and in so doing adds to the legitimacy and effectiveness of specific regulations and financial sector governance in general. Stakeholder participation lends greater weight to the law to the extent that it involves subjects in the very process of policy formulation. Such participation also makes it difficult for regulated parties to argue that the law is unworkable and a product of unilateral, non-consultative, processes. Open processes and public records also provide transparency and guidance to stakeholders seeking directions on the nature of such policy.

[14]The extent of appropriate deference to administrative agency policy decisions is a huge matter of scholarly concern that is not fully settled. *See*, Ekta Shakti Foundation v. Govt. of NCT of Delhi, 2006 AIR 2609, 2006(10)SCC337 (2006) (Noting that in "matter of policy decisions or exercise of discretion by the Government so long as the infringement of fundamental right is not shown Courts will have no occasion to interfere and the Court will not and should not substitute its own judgment for the judgment of the executive in such matters. In assessing the propriety of a decision of the Government the Court cannot interfere even if a second view is possible from that of the Government."); Chevron U.S.A. Inc. v. Natural Resources Defense Council, Inc., 467 U.S. 837, 842-45 (1984) (reflecting settled constitutional doctrine in the US requiring courts to defer to an agency's interpretation of a statute unless the U.S. Congress has directly determined the issue under consideration); *See also*, Steven G. Calabresi & Saikrishna B. Prakash, *The President's Power to Execute the Laws*, 104 YALE L.J. (1994), and Frank H. Easterbrook, *Unitary Executive Interpretation: A Comment*, 15 CARDOZO L. REV. 313, 318-319 (1993), and Lawrence Lessig & Cass R. Sunstein, *The President and the Administration*, 94 COLUM. L. REV. 1, 93-106 (1994) and Cynthia R. Farina, *The Consent of the Governed: Against Simple Rules for a Complex World*, 72 CHI.-KENT L. REV. 987 (1997)(debating broader issues of separation of powers and institutional and constitutional design.)

[15]*See*, Forward Contracts (Regulation) Amendment Bill, 2006, §5 (Lapsed bill that would have made orders of the Forward Markets Commission appealable to the Securities Appellate Tribunal).

Consultation can also provide a well-developed record that can deepen the quality of judicial review.[16] "Notice and comment" procedures are a routine, uncontroversial part of administrative agency practice in OECD countries.[17] SEBI has an official process of informal consultation to guide market participants. Market participants are also free to approach the RBI unofficially.

The working group notes that the formality of consultation and range of issues subject to consideration is important. Formalizing consultation processes can easily become mechanical and simply add additional layers to bureaucracy. Formalizing (here consultation) procedures can also create pressure points where regulators can be sued for not following process rules. This, in turn, becomes a means of "jamming the works." Moreover, forced or public consultation on matters involving first mover advantage, for matters such as product approvals, can severely limit incentives to innovate.[18] Yet, consultation prior to policy formulation provides richer, more responsive feedback to regulators. Institutionalizing consultation also provides certainty to market participants. Constructing formal consultation processes creates identifiable timeline for policy proposals to be processed and allows participants time to adjust to what would otherwise be abrupt shifts in policy. Furthermore, having broad processes of consultation involving varied stakeholders can work to limit regulatory capture.

Regulatory statements of intent or purpose can also be of significant assistance to market participants in understanding the regulatory intent behind a given policy position. Regulatory statements of intent provide a sense of context and allow for more clear understandings of the law. Conversely, regulators may value the discretion afforded by not having to make explicit statements beyond the actual language of a regulation or directive in matters where the promulgation of such law is complicated or overly "political."

4.3.2. *Recommendations*

While there has been progress over the years in including consultation before introducing policy or process changes by regulators, the working group recommends the institution of required processes of public consultation before issuing any directives of law and policy. In general, the working group urges the creation of transparent and approachable frameworks for access to the administrators of financial regulation for interpretation and clarity in areas of ambiguity. Material changes or developments in policy should be preceded by a period of consultation so that stakeholders can have a clear sense of the intent, scope and impact of proposed policy changes. Consultation on matters of policy could take the form of public hearings or periods of open comment on policy matters. Regulators can also solicit and receive feedback on matters of regulatory policy through the Internet. The use of tailored questionnaires and related techniques can help ensure focused responses to policy questions as opposed to political campaigning through electronic mailings.[19] Participation in consultation

[16] 2 Am. Jur. 2d Administrative Law §153. (American Jurisprudence, 2nd Edition, the staple encyclopedia of U.S. law libraries, discussing the purpose of "notice and comment" procedures in American law.)

[17] *Id.*; Financial Services Maintenance Act, 2000 (UK), Part I, §8; *See also*, Commission Proposal for General Principles and Minimum Standards for Consultation of Interested Parties by the Commission, COM (2002) 277 final (June 5, 2002)(discussing proposals of the Commission for the European Union on stakeholder consultation and reports.

[18] For example, a given product that may take months to develop could be copied in a matter of hours. Making product design a matter of public knowledge through the processes of consultation would limit the incentive of financial firms to invest in research and innovative means of intermediation.

[19] *See*, Securities and Exchange Board of India, Takeover Regulations Advisory Committee solicits inputs / suggestions from public on Takeover Regulations (2009), http://www.sebi.gov.in/Index.jsp?contentDisp=SubSection&sec_id=25&sub_sec_id=25 (Soliciting public comment on proposed changes to Takeover Regulations in a structured manner).

processes should be made a matter of public record. Regulators should also consider whether or not to issue statements of purpose accompanying any promulgation of policy to provide guidance to market participants as to intent.

Consultation can also include regulated parties seeking clarification and guidance for specific transactions. Here the working group notes that requests for guidance on product specific matters involves commercially sensitive information and should not be made public. A particular party may take months to develop a given product that could in turn be copied in hours if made public. Regulated parties should not be penalized for seeking to better understand and comply with the law. Exceptions to openness principles could be limited to specific transactions, for specified periods of time.

Finally, in structuring processes of consultation, the working group cautions regulators to guard against regulatory capture yet urges agencies not to over-bureaucratize interactions with stakeholders. In developing ways to address regulatory capture, there perhaps exists a spectrum ranging from hortatory codes of conduct to detailed rules. The working group considered whether adding formal layers of rules merely adds costs and just privileges those who can hire lawyers or whether such rules are indeed needed to avoid capture. In any case, without resolving the details of this particular issue, the working group felt it important to emphasize the values to governance in participation, legitimacy and quality of law facilitated by consultation.

4.4. Information management: Transparency and certainty

4.4.1. *Current arrangements*

Information management is a prosaic, but nonetheless crucial part of providing transparency and legal certainty. Providing ready, specific access to information about directives, notifications and agency matters is important for reasons of openness, inspiring confidence in the quality of, and facilitating and promoting reliance on, the law. Indeed, the working group notes that difficulties and frictions in accessing information about India's capital flows management regime is, bracketing questions of capital account convertibility, one of largest obstacles to foreign investment in the country. The Tarapore Committee has commented broadly that the "vibrancy and strength of the physical infrastructure of markets as reflected by...IT systems," is one of the three main dimensions of a well developed financial system.[20]

SEBI, RBI and the Ministry of Finance host extensive websites that offer access to circulars, press notes, speeches and other matters.[21] Yet all sites have their limitations. The Ministry of Finance website links to FEMA regulations, for example, are listed in hyperlinks by a code (i.e. "GSR 396E" for FEMA notification number 13 of March 3, 2000) that is not readily recognizable, let alone easily searchable for most. FEMA links are also not complete; links to ECB rules are not provided, for example.

The RBI website provides significant and extensive amounts of information, but does not go the extra step of providing consolidated statements of regulation as currently amended. For example, the RBI website provides a comprehensive list of notifications that go back in time, an important feature for investors needing to understand the state of the law at a given point in time. The RBI website provides a search engine internal to the website. Yet the hyperlinks to law in both websites are organized in

[20]Reserve Bank of India, Report of the Committee on Fuller Capital Account Convertibility 138 (2006) [hereinafter Tarapore Committee Report.]

[21]*See*, SEBI website, http://www.sebi.gov.in; RBI website, http://www.rbi.org.in/; Ministry of Finance website, http://www.finmin.nic.in/

bulletin board style, namely, the latest ruling in time is posted at the top of that section of the website. Investors have to patch together a number of different documents to discern the letter of the law on a given subject. So, a hypothetical investor charged with violating a provision of the regulation FEMA 20 would have to wade through the many notifications amending those regulations over the years to piece together a sense of the provisions of these regulations at a given point in time. S/he would not be able to find a statement of the provisions of FEMA 20, as amended, on the RBI website respectively, but would have to rely on private sources or master circulars. Master circulars do present a consolidated digest of the law prevailing as of the date of the master circular but do not allow a person to discern the specific position of law at a specific point in time. Private sources of law are not authoritative and often contain mistakes in their representations of regulation. RBI master circulars ask readers to refer to underlying notifications and, as such, for investors seeking legal certainty, are not complete statements of law in and of themselves. Furthermore master circulars are not issued through the formal process for issuing regulations though members noted that master circulars may still be upheld by courts of law.

The SEBI website also provides extensive amounts of information but could be made more user-friendly. The SEBI website provides comprehensive access to current notifications. The website also allows searches by categories such as "FIIs," "Issues and Listing," "Demat/Depositories," "Venture Capital," "Derivatives," "Legal Affairs," the "Corp Debt Market" and more. Yet, the categories are not comprehensive and law is presented in other parts of the website affecting each of these entities.[22] Moreover, SEBI does not provide prior versions of a given notification on the website. A market participant charged with a violation at a given point in time would not have access to a snapshot of the law at that point in time. SEBI's search option is also not complete. While SEBI categorizes information in a multiplicity of categories, searches are facilitated for only a few of these categories. Yet the SEBI website does not classify orders passed by the Board in a clearly discernible manner or help the reader understand the regulations to which they pertain.

In comparison, for example, the UK FSA site is organized thematically. Provisions of law are available by sector, regulatory topic, on a personalized basis or in full. Hyperlinks provide immediate access to relevant provisions of law. Cross-referencing and links to explanations or clarifications of regulations also help. Our analysis is not new. The Tarapore Committee also has discussed the need for a broad upgradation of IT systems.[23]

4.4.2. *Recommendations: Real time access to the law*

The working group recommends the creation of more user-friendly access to the law through public information systems. This should include comprehensive websites on capital flows that provide immediate access to current positions of law in a comprehensive and organized manner that are both updated regularly and provide accessible history of relevant provisions.[24] Reasoned orders of specialised tribunals should also be published in an organised fashion to build precedent and jurisprudence.

Information management should also include the creation of real time portfolio investment manuals. Such manuals should:

[22] For example, the First Global (UK) Ltd order discussed in Box 1 is not found in the section which provides information for FIIs, though the case is clearly of significant precedential value.

[23] Tarapore Committee Report, *supra*, note 20, at 140 (Recommending the upgrading of IT-based surveillance systems in the RBI.)

[24] In particular, the working group refers to current practices of simply piling collections of notices serially that require extensive sorting or professional knowledge of prior circulars and legal notices to arrive at a clear understanding of current law in a given area.

Box 4.3: Master circulars that add new law

Master circulars are thought of as compendiums of all law codified particular notifications and regulations. As a matter of proper legal process or, at minimum, avoiding confusion, master circulars should either leave existing positions of law unchanged, or, if new positions of law are introduced, be accompanied by changes to underlying and related regulations. Such changes or new codifications of law should be issued through the formal processes for issuing regulations.

For example, there are two ways of accessing External Commercial Borrowings under FEMA; the automatic route and the approval route.

Pursuant to FEMA regulations, a non-governmental institution or organisation engaged in micro-finance activities ("MFI") may borrow through the automatic route. However, the Master Circular on ECBs for 2008 required MFIs, to borrow through the approvals route without any change in the relevant regulations and schedules. In 2009, the Master Circular on ECBs placed MFIs, back under the automatic route, with added conditions. Once again these measures were taken without any change to the governing regulations.

Sources: Foreign Exchange Management(Borrowing or Lending in Foreign Exchange) Regulations, 2000 Schedule I *at* Paragraph 1.(i)(b); Master Circular on External Commercial Borrowings and Trade Credits, Master Circular No./07/2008-09 dated July 1, 2008 *at* Part I, I(B)(i)(h); Master Circular on External Commercial Borrowings and Trade Credits, Master Circular No./07/2009-10 dated July 1, 2009 *at* Part I, I(A)(i)(c).

1. Be current, legally accurate and authoritative;
2. Parties should be able to rely on the provisions;
3. These documents should be internally and externally consistent;
4. Statements of law in these documents should not be contradicted by other sources or government entities;
5. Manuals should also be complete;
6. Parties should not have to refer to other documents in the normal course of business.
7. There should be no dissemination of law through informal channels.

Parenthetically, the working group notes that Right to Information Act ("RTI") compliance should also be an important part of agency due diligence. Though the working group did not deliberate on RTI matters at length, providing access to required information is an important part of cultivating public cultures of transparency and good governance.

4.5. Role of law departments: Quality of law

4.5.1. *Current arrangements*

Law departments are typically not active participants in agency policy decision making. Law department involvement is typically limited to vetting finalized policy proposals and are often seen as merely trouble-shooting. Indeed, law departments are too often called upon only at the stage of defending a regulatory action or challenge in a court of law. As such, policy instruments, laws, are often not formulated with the particular institutional concerns of the law or a given policy arena taken together. The result, in effect, is inaccurate drafting and instruments that have the force and effect of law but that may not fully achieve the policy and legal goals these instruments are intended to serve.

The reasons for this phenomena may be perception. The issuance of circulars and press notes are not always seen as law (and, formally speaking, do not carry the

authority of parliamentary statute or subsidiary agency regulation) though these directives shape market behaviour and are treated, in practice, as law by both regulators and market participants.

4.5.2. *Recommendations*

The working group recommends that law departments be centrally involved in the framing of policy. As the working group has emphasized, rule of law concerns should not be seen as afterthoughts but as important values for reasons of inherent legitimacy of government processes as well as market integrity, protection of property rights and confidence of investors in the soundness of India's markets. What regulators may see as mere circulars are regarded as law and accordingly shape market behaviour. As such, legal instruments should be drafted with rule of law concerns in mind. Concomitant law department involvement in policy formation is vital to the development of effective law that meets the stated purposes of regulators and government, whatever these may be in given moments.

CHAPTER 5

QFI: A single window for portfolio investment

India's decision to give "foreign institutional investors" the ability to bring and take money into and out of the economy, without quantitative restrictions has been a momentous occasion in the country's economic history. From the perspectives of macroeconomic policy, the decision to allow FII participation in the economy has moved the country in the direction of full capital account convertibility.

Considerable benefits have been obtained for the Indian economy from these reforms. An analysis of the balance sheet of 6626 listed firms on 31 March 2009 shows FII investments of market value of Rs.3.639 trillion. This made up 19.01 percent of the overall net worth of these firms. The overall balance sheet size of these firms was Rs.86.02 trillion or 164.51 percent of 2008-09 GDP.[1]

If foreign investment makes up an important portion of the economy, foreign investors also face onerous transactions costs.[2] At any given level of convertibility, an ad hoc administrative arrangement of sometimes overlapping, sometimes contradictory and sometimes non-existent rules for different categories of players has created problems of regulatory arbitrage and lack of transparency. These transactions costs increase the cost of capital faced by Indian recipients of foreign equity capital.

Security concerns also effect economic policy. In recent years, concerns related to money laundering and terrorist financing have grown in significance. The working group also questions whether present regulatory frameworks are complete and sufficient to track investments into the economy for these purposes.

[1]We note that bank balance sheets should not be interpreted in the same manner as the balance sheets of ordinary firms where the balance sheet size measures the magnitude of capital that the firm brings to bear in order to produce goods or services. Simply put, banks borrow money from people, and some of this capital comes back into building the balance sheets of firms. This leads to some double-counting. Ideally, we would remove banking from calculations like this to avoid over-statements of balance sheet size but do not do so in the body of the report to avoid having to present an overly technical narrative, the nuances of which may be of less interest to the generalist reader. Our rough calculations are that GDP and non-banking balance sheet size are both roughly Rs.55 trillion or 100 percent of GDP.

[2]The calibrated and timed opening of the Indian markets led to creation of different regulated entities at different points of time. Until 1992, Indian companies where non-resident interest exceeded 40 percent were subject to regulation under sections 28, 29 and 30 of the Foreign Exchange Regulation Act, 1973 or "FERA" as "FERA companies". *See*, Foreign Exchange Regulation Act §28-30 (1973); FIIs, of course, were created in 1992 and predate FEMA. *See*, Old Guidelines for Foreign Institutional Investors, Department of Economic Affairs, Ministry of Finance, Press Note of 14th September, 1992. Regulation of foreign venture capital investors began only in 2000. *See*, SEBI (Foreign Venture Capital Investors) Regulations, 2000. Some entities, like 'Overseas Corporate Bodies ("OCB") have been phased out.

The initial section will present the current law of foreign investment. In particular, this section examines the law governing foreigners investment into listed and unlisted equity in India, the most prominent manifestation of these themes. The subsequent section lays out our analysis. Subsections will examine, in turn, issues of home bias, complexity and transaction costs, enforcement matters and country comparisons. The third section then presents perhaps the signal recommendation of this report, a single window for portfolio investment regulations for Qualified Financial Investors. Consecutive subsections will present what we mean in proposing the QFI framework, as well as related matters of Know Your Client/Customer norms and attendant legal changes that would be involved with developing such a framework.

5.1. Current Law

5.1.1. *Inflows into listed equity*

Inflows into listed equity must be directed through certain specified channels. Foreign corporations, funds or individuals who meet the criteria for registering as a FII or sub-account thereof, and who register with SEBI, are allowed to invest in the securities of an Indian company under the Portfolio Investment Scheme, subject to specified ceilings.[3]

FIIs are allowed investment in listed equity under the portfolio investment scheme subject to specified investment ceilings applicable to listed or unlisted equity. In particular, foreign corporations, funds or individuals who meet the criteria for registering as a FII or sub-account thereof,[4] and who register with SEBI, are allowed to invest in the securities of an Indian company up to a ceiling of 10 percent for each FII or sub-account.[5] The investments of all FIIs and sub-accounts in a given listed Indian company are capped at 24 percent of the paid-up equity capital of that company.[6] Note though, that the cap for all FIIs and sub-accounts taken together may be raised up by a company up to the sectoral cap for foreign direct investment.[7] FIIs may also invest in units of domestic mutual funds.[8]

Foreign venture capital funds ("FVCIs") are allowed to invest up to one-third of their funds in specified forms of listed equity.[9] FVCIs do not have explicit authorization to invest in the units of domestic mutual funds.[10]

[3]Foreign Exchange Management (Transfer or Issue of Security by a Person Resident outside India) Regulations, 2000, [hereinafter FEMA 20] Regulation 5(2) and Schedule 2; SEBI (Foreign Institutional Investors) Regulations, 1995, [hereinafter SEBI FII Regulations] Regulation 15(1)(a).

[4]SEBI (FII) Regulations at Regulations 6-13.

[5]FEMA 20 at Regulation 5(2) and Schedule 2, Paragraph (4). Note that if a sub-account belongs to an individual or foreign corporation (as opposed to a broad based fund, charitable trust or university fund, endowment, foundation or proprietary fund of a registered FII), then the limit is 5 percent. SEBI FII Regulations, at Regulation 13(1)(a), and 15(5).

[6]FEMA 20 at Regulation 5(2) and Schedule 2, Paragraph 4.

[7]FEMA 20, *supra* note 3, at Regulation 5(2) and Schedule 2; SEBI (FII) Regulations, *supra* note 3, at Regulations 15(1)(a). FEMA and SEBI regulations allow FIIs to invest in securities in primary and secondary markets up to a limit of 10 percent of total paid-up equity capital per FII or 24 percent for all FIIs and their sub-accounts taken together. This amount may be raised up to the FDI ceiling or sectoral cap on passage of a resolution by the Indian company's board of directors. In effect, FEMA grants listed companies the power to discriminate against foreign investors, a power potentially in conflict with principles of Companies law.

[8]FEMA 20, *supra* note 3, at Regulation 5(3)(i) and Schedule 5; SEBI (FII) Regulations, supra note 3, at Regulations 15(1)(b).

[9]*Id.* at Regulation 5(5) and Schedule 6; SEBI (Foreign Venture Capital Investors) Regulations, 2000 at Regulation 11(c)(ii)(a)- (c). In particular, foreign venture capital funds may invest in IPOs of venture capital undertaking where the shares are proposed to be listed, debt or debt instruments of venture capital undertakings where the foreign VC has already made an investment by way of equity and preferential allotment of equity shares of a listed company subject to a lock-in period of one year.

[10]FEMA 20, *supra* note 3, at Regulation 3.

Non-resident Indians ("NRIs") are allowed restricted investment in listed equity through the Portfolio Investment Scheme.[11] FEMA regulations allow individual investment of up to 5 percent of the total paid value of shares issued by an Indian company subject to an aggregate 10 percent cap for all NRIs investing in that organization.[12] Save purchases of equity in certain narrowly defined categories,[13] NRIs are prohibited from purchasing shares of chit funds, nidhi companies or companies involved in agricultural, plantation, real estate or farm house construction as well as those dealing in Transfer of Development Rights. NRIs are allowed unlimited investment in unlisted equity, including through private placement, but only on a non-repatriable basis.[14] NRIs are also allowed to purchase unlimited units of mutual funds on the basis of either repatriation or non-repatriation.[15]

5.1.2. *Inflows into unlisted equity*

At a conceptual level, a private equity or venture capital fund outside India can invest in India in three ways. First, private investment in unlisted equity can take place if the foreign entity creates an investment vehicle which obtains an FII registration.[16] Second, even without registering as an FII a private equity or venture capital fund outside India can invest in an Indian unlisted company up to the level of caps for FIIs. These investments would be treated as FDI, which generally is beyond the purview of this working group. These two mechanisms, put together, characterize the main avenues for private equity/venture capital inflows into India. The third way for private equity or venture capital funds outside India to invest in the country is to register as an FVCI with SEBI and be regulated as such.

As a matter of law, formally registered foreign venture capital investors are allowed to invest in unlisted equity.[17] Indeed, foreign venture capital investors are required to invest at least 66.67 percent of investible funds in unlisted equity or shares of equity-linked instruments of a venture capital undertaking.[18] FVCIs can also invest in domestic venture capital funds.[19] The RBI gives also permissions to open bank accounts.[20] Funds are required to disclose their future investment strategy, areas of investment, total corpus and life. The RBI may attach any conditions to permissions perceived as necessary.[21]

FVCI regulations were originally created to offer special conveniences and incentives to foster private equity/venture capital investment. As a practical matter, these

[11]Of course these restrictions on NRI investments can be seen in many lights. Foreigners are not allowed to make direct portfolio investments at all into India and must first register as a FII. This of course is a reflection of early liberalization policy decisions to gradually open the Indian economy through openings to registered foreign institutional investors and non-resident Indians. As a practical matter, as will be discussed below, these regulations, in the context of current regulatory frameworks, are seen by investors as burdening NRI investments to the extent that foreign nationals investing through a FII would be treated differently than NRIs investing directly or through a FII.

[12]*Id.* at Regulation 5(3)(i) and Schedule 3.

[13]*Id.* at Regulation 5(4), Schedule 5.

[14]*Id.* at Regulation 5(3) (ii) and Schedule 4, Paragraph 1.

[15]*Id.* at Regulation 5(4) and Schedule 5, Paragraph 2(1A)(i) and 2(2). Paragraph 2(1A)(i) allows unlimited NRI purchase of the shares of domestic mutual funds on a repatriation basis. Paragraph 2(2) allows the same on a non-repatriation basis. Ostensibly the two paragraphs should be read in such a way as to not contradict each other (i.e. if the NRI investor is said to have the choice between unlimited investments in mutuals on either repatriable or non-repatriable basis). Though to the extent that most NRIs would not choose to voluntarily restrict their investment, this clause appears redundant or, at minimum, could bear clarification as to intent.

[16]SEBI (FII) Regulations, *supra* note 3, at §§3-13A.

[17]FEMA 20, *supra* note 3, at Regulation 5(5) and Schedule 6.

[18]SEBI (Foreign Venture Capital Investors) Regulations, 2000 at Regulation 11(c)(ii)(a) and (b).

[19]SEBI (Foreign Venture Capital Investors) Regulations, 2000 *supra*, note 18 at Regulation 11.

[20]FEMA 20, *supra* note 3, at Regulation 5(5) and Schedule 6, Paragraph 2.

[21]FEMA 20, *supra* note 3, at Regulation 5(5) and Schedule 6, Paragraph 1(1).

conveniences and incentives are largely limited to exemptions from regulations regarding the following of pricing guidelines[22] as well as lock-in requirements.[23] Until recently, the RBI had not approved FVCI registrations for quite some time and conditioned the receipt of benefits allowed to FVCIs to investments in 10 sectors; the 9 sectors listed in the IT Act[24] with dairy and poultry listed as separate sectors by the RBI.[25] Additionally, FVCIs do not appear to be permitted to acquire existing shares in venture capital undertakings. The RBI appears to have taken the position that FVCIs can only invest in fresh equity issued by a venture capital undertaking. This position is not reflected in FEMA, but has instead been conveyed by the RBI to authorised forex dealers.

5.2. Analysis

5.2.1. *Home bias*

The FII framework worked well at a certain historical juncture when India was first opening a largely closed economy. With the benefit of 15 years of experience, certain difficulties, notably that of home bias, are visible. Home bias refers to the tendency of foreign investors to overweight their portfolios with holdings from their home country and to minimize investment in foreign firms. Indian firms are punished by the home bias of foreign investors by losing access to capital. Home bias is caused by a combination of lack of information and analysis, and capital flows management regulations.

India has made some progress on alleviating the home bias suffered by Indian firms. Table 5.1 shows how FII ownership of private firms in the CMIE database varies by size. For the 636 firms in the biggest decile, as much as 17.71 percent of the equity capital has come from foreign investors. But this percentage drops off dramatically as we examine smaller firms. The vast fraction of firms have essentially no FII investment.

Our analysis suggests that the benefits of reduced cost of capital are, at present, mostly confined to the largest Indian firms. In a certain sense, these developments have given large firms a competitive advantage and handicapped smaller firms who have been unable to break through the home bias of foreign investors.

[22] FEMA 20, *supra* note 3, at Schedule 6, Paragraph 4 (simply stating that FVCIs may acquire or purchase shares at a price acceptable to buyers and sellers) and Schedule 1, Paragraph 5(otherwise requiring that the price of shares issued to non-residents be set in accordance with specified pricing guidelines).

[23] SEBI (Foreign Venture Capital Investors) Regulations, 2000 *supra*, note 18 at Paragraph 11c(ii)(stating that not more than 33.33 percent of investible funds may be invested by way of subscription to an initial public offering, but not requiring any lock-in period for holding of such shares); *See also*, SEBI (Foreign Venture Capital Investors)(Amendment) Regulations, 2004, Section 2(b)(ii)(2) (removing language requiring lock-in periods of one year).

[24] INCOME TAX ACT,1961, §10(23FB).

[25] The RBI restricted FVCI registration through their control over FVCI ability to open bank accounts. FEMA regulations authorize the creation of specific types of bank accounts for foreign residents (both Non-Resident Indians and persons resident outside India). *See*, Foreign Exchange Management (Deposit) Regulations, 2000 [hereinafter FEMA Deposit Regulations]. For FVCIs, two new types of accounts have been created, though the authority for the creation of these accounts is provided by different regulations; the "Foreign Currency Account" and "Rupee Account". *See*, FEMA 20, *supra* note 3, at Regulation 5(5) and Schedule 6, Paragraph 2. As demonstrated above, these accounts require RBI permission. Permissions granted by the RBI appear to have been tied to requirements such as investment in only the nine sectors mentioned for tax-pass through treatment in the Income Tax Act; *See also*, Draft Direct Taxes Code , 2009, released for public reaction, §10, §174(b)and(c), §310, §311 and Schedule 7, Paragraph 15-17 (The Draft Direct Taxes Code if enacted in its present form would remove the nine-sector limitation of tax-pass through benefits). Note that this matter involves registration and only indirectly tax pass through rights. Tax pass through rights only affect FVCIs tangentially, to the extent that FVCIs invest in domestic venture capital funds and doesn't affect direct investment into Indian companies. FVCI registration is also important to the extent that FVCIs are provided with approvals under FEMA to invest in Indian securities within the scope permitted under SEBI (FVCI) Regulations.

Table 5.1: FII ownership by size deciles (31 March 2010)

Decile	FII ownership (Per cent)
Big	17.71
9	5.23
8	3.26
7	3.67
6	1.19
5	1.05
4	0.01
3	0.87
2	0.01
Small	0.03
Overall	16.72

Source: CMIE Prowess database.

5.2.2. *Complexity and transaction costs*

Foreign investment in India is also coloured by transactions costs. The regulation of listed and unlisted equity is characterised by complex regulation. Multiple regulators directing different categories of investors, as opposed to markets, in often overlapping fashion, creates inconsistencies, reduces transparency and accountability, and increases overhead costs. These frictions inevitably translate into an elevated cost of capital for Indian firms who are accessing foreign equity capital.

The problem of home bias and the problem of elevated transactions costs are related. Overcoming home bias requires removing frictions. Foreign investors might be willing to accept additional costs caused by policy or procedural hurdles when investing in the largest of Indian firms. Yet such hurdles block investment into smaller firms at ultimate cost to the Indian economy. The true measure of deep engagement by foreigners with India, and maximizing the resources available for economic development, is the extent to which these investors have the incentives to learn Indian companies well, and the extent to which investment into smaller firms is deep-rooted. This, in turn, requires removing the practical hurdles which inhibit foreign investment.

For example, while, as a matter of law, inflows into listed equity are fairly open, individuals and corporations are faced with unnecessary complexity in the form of separate regulation for different categories of investors and sub-account holders. This includes the formal Foreign Institutional Investor, Foreign Venture Capital Investor and Non-Resident Indian designations in addition to Foreign Direct Investment ("FDI"). These investments are regulated and/or monitored in turn by the RBI, SEBI, the Department of Industrial Policy and Promotion and the Ministry of Finance. While FDI policy is beyond the remit of this working group, the presence of multiple regulators and multiple routes for channeling the same investment encourages creative structuring of investments to skirt the letter of the law.

To use a different example, the framework for regulating NRI[26] investment was created at a particular point in India's integration into the market. However, with the passage of time, initial benefits granted to NRI investors in the context of a more

[26]NRIs are perhaps most easily thought of as non-resident nationals, though this is, technically, an oversimplification. The term 'Non Resident Indian' has many different definitions in FEMA regulations with enough, slight, differences to create operational problems for investment funds seeking to include NRI investments. *See*, Kuruvila, Bikku, NRIs as a Barometer for India's Processes of Financial Intermediation: Removing Restrictions that Discriminate Against NRI Investment in India.(June 15, 2009)(unpublished manuscript, on file with the National Institute of Public Finance and Policy).

closed economy have been bypassed, which creates unnecessary complexities for foreign investors. Notably, foreign institutional investors are allowed to invest in equities at higher levels than NRIs.[27] Of course foreign nationals interested in investing in India must register as FIIs, may not invest directly, and are formally disadvantaged compared to NRIs who may invest directly in a limited manner. Yet investment funds registered as FIIs considering NRI participants are faced with situations where they would have to create complex accounting structures to monitor pooled funds, given the distinctions in permissible investments for the two categories of investors, which creates disincentives to allowing such participation. These effective limits on NRI investment have continued for some time are of course a reflection of early liberalization policy decisions to gradually open the Indian economy through openings to non-resident Indians which have now been bypassed by benefits granted to formally registered FIIs. In this light, the interplay of FII and NRI regulations have caused confusion regarding the treatment of NRI investments for some time.[28]

Regulation of listed equity is also marked by the use of quantitative restrictions on portfolio holdings, procedural constraints on outflows depending on investor type and lack of strong Know-Your-Client/Customer requirements.

The regulation of investment into unlisted equity is also characterized by complexity. Specific capital flows management regulation apply to specific types of investors such as private equity and venture capital. Procedures must be followed, and delays have been possible, even under the 'automatic' route.[29] Sectoral restrictions on foreign investment apply. As discussed above, benefits created for specific categories of investors, like foreign venture capital investors, have been restricted to the point where the utility of this particular investment vehicle appears unclear.[30]

The working group notes that until recently the RBI did not approve FVCI registrations for significant lengths of time. When the RBI eventually resumed issuing approvals, conditions were inserted that only investments in the 9 or 10 sectors referenced in the IT Act would be eligible to receive the concessions or incentives available to FVCIs.

Additionally, the RBI has sought undertakings from potential registrants with regard to investment in real estate, although investing in real estate is not part of the negative list prescribed in SEBI (FVCI) Regulations.[31] These measures intend to address asset price bubbles in real estate. However, to the extent that FVCIs can also invest as FDI, this action has had no impact on the ground other than to create regulatory flux and attendant friction. The working group is concerned that these delays in registration go beyond the original intent of policy in incentivising venture capital.

[27] FEMA 20, *supra* note 3, Schedules 2, 3. (Allowing NRIs to invest up to five percent individually and up to ten percent in aggregate terms of the paid-up value of shares (or series of convertible debentures) of an Indian company under the portfolio investment scheme. In contrast, FIIs are allowed to invest up to ten percent individually and twenty-four percent in total.)

[28] Some members commented that for a period, SEBI thinking was that funds seeking to register as FIIs should not have NRIs as investors in the funds. This was never officially articulated or expressed, but in practice, funds seeking registration were required to disclose their investor profile, and funds with NRI investors experienced difficulty in getting registered. NRI investments in funds seeking FII registration is no longer an issue. At one stage, SEBI did not register investment managers as FIIs even if they otherwise met SEBI's norms for registration, if the investment manager was owned or substantially owned by NRIs. Again, there was no explicit provision in SEBI regulations in this regard. Currently, we understand that SEBI does not apply this test for registration.

[29] Members discussed investors having to apply in writing for approval of investments under the automatic route, and meetings needing to be held by the RBI to approve the same. Further, while investments would be routinely approved at meetings, the RBI, in the past, would often not schedule meetings.

[30] *See also*,Income Tax Act, *supra* note 24 and accompanying text(discussing RBI reference to the Income Tax Act to restrict FVCI investment to 9 sectors ranging from biotechnology to poultry.)

[31] SEBI (Foreign Venture Capital Investors) Regulations, 2000 at *supra*, note 18, Third Schedule.

Under general principles of taxation, either a trust or its beneficiaries are taxed. Financial trusts are seen as merely aggregations of beneficiaries. With FVCIs beneficiaries reside in countries which often have double taxation avoidance agreements ("DTAAs") with India. To tax the trust effectively defeats DTAAs to the extent that investors who individually would be exempt from taxation under provisions of that DTAA now face taxation through the trust.[32] The issue of taxation becomes relevant for FVCIs to the extent of their investment into VCFs as it potentially affects how the FVCIs income gets taxed in India. Members expressed concern that the structure of taxation may limit the number of venture capital funds being registered in India. Members also noted, however, that the Draft Direct Taxes Code would address these concerns.

Investors must factor in considerations of repatriation versus non-repatriation,[33] misaligned incentive structures and lack of certainty about approval of one given structure. In particular, investment into unlisted equity is largely directed through the formal FII and VC schemes administered by SEBI. Individuals and mutuals do have limited authorization to invest in unlisted equity abroad. Existing regulation of unlisted equity can be compartmentalized into the rules applicable to individual and institutional actors, by types of equity, and by inflows and outflows. Legally recognized subjects of regulation include private individuals and Non-Resident Indians, foreign institutional investors, corporations (Indian companies), domestic venture capital funds, foreign venture capital investors as well as mutual and pension funds.

Our analysis is not new. The Tarapore Committee on fuller capital account convertibility notes that historically, regulation of capital flows has proceeded through monitoring myriad specific schemes.[34] The Tarapore Committee states that while capital flows management regulations have been liberalised to a significant extent, the relaxation of this framework has proceeded on an ad hoc basis.[35] Tarapore notes that there are a number of restrictions, like NRI investments, that date to a period of more restrictive regulation and that should be removed before liberalisation can become meaningful.[36] Indeed, the Tarapore Committee stated: "there should be a rationalisation/simplification of the regulatory system and procedures in a manner wherein there can be a viable and meaningful monitoring of these flows."[37] Also, the "substantive items subject to foreign exchange control regulations should be separated from the procedural issues."[38]

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[32]Domestic investors are also double-taxed, once at the level of the trust and once individually.

[33]Also an example of regulatory overlap, pursuant to FEMA regulation, NRIs are allowed to purchase an unlimited amount of shares or convertible debentures of an Indian company issued whether by public issue or private placement or right issue, except a chit fund or a nidhi company or a company engaged in agricultural or plantation activities or real estate business or construction of farm houses or dealing in transfer of development rights. Pursuant to FEMA regulation, these purchases are explicitly not repatriable. *See*, FEMA 20, *supra* note 3, at Schedule 4. This schedule explicitly states, in its very title as well as in its text, that purchase and sale of shares or convertible debentures by a Non-Resident Indian is not repatriable. Schedule 3 of the same Regulation also provides for investment up to a specified percentage of shares in repatriable investment under the Portfolio Investment Scheme. *See*, *Id*. at Schedule 3. Yet, Press Notes issued by the Secretariat for Industrial Assistance ("SIA") within DIPP equally explicitly hold that NRI investment in foreign exchange is *fully* repatriable (*See*, Department of Industrial Policy and Promotion, Ministry of Commerce and Industry, Press Note 4 of 2001) and that non-repatriable NRI equity may be converted into repatriable equity to the extent that the original investment by the NRI was made in foreign exchange and the sector or activity involved by the equity is on the automatic route for foreign direct investment. *See*, Department of Industrial Policy and Promotion, Ministry of Commerce and Industry, Press Note 4 of 2005.

[34]Report of the Committee on Fuller Capital Account Convertibility 130 (2006)[hereinafter Tarapore Committee Report].

[35]*Id*.

[36]*Id*. at 141.(Finding that "the knots in the forex management system need to be untied before the liberalisation can become meaningful.")

[37]*Id*. The Tarapore Committee notes further that this consolidation should be an early one.

[38]*Id*.

5.2.3. *Enforcement*

The foreign investment framework established in the early 1990s, and incrementally modified thereafter, imposes higher transactions costs which (in turn) induce an elevated cost of capital and heightened home bias. The current foreign investment framework also raises questions regarding the post 9/11 focus on countering the financing of terror, and anti-money-laundering. Two other significant dimensions of enforcement are tax evasion and enforcement of rules against market manipulation on securities markets.

In security terms, the present regulatory framework is not well suited for tracking investments into the economy to address these problems of enforcement. The working group noted that all across OECD, countries have full capital account convertibility alongside high levels of tax compliance, enforcement against organised crime and terrorism, and supervisory effort against market manipulation on the securities markets. Hence, there is no contradiction between an open economy on one hand and high quality enforcement in all three dimensions.

Under the present regime, since registration is layered and the present avenues for investment into the economy are complex, complicated transactions with attendant frictions and legal costs may be the only way to invest into India. To the extent that the regulatory system requires complex financial engineering on an everyday basis, the task of the police, tax authorities and securities markets regulators is made more complicated.

For example,"round-tripping" is a significant issue for tax compliance. The regulator should have enough powers to investigate, demand documents and inspect an audit trail so as to satisfy itself fully regarding suspicions of instances of market manipulation, whether "round tripping" by Indian nationals or other actors. The RBI currently stipulates KYC norms and Anti-Money Laundering obligations for banks in light of recommendations of the Financial Action Task Force ("FATF") on Anti-Money Laundering ("AML") standards and on Combating the Financing of Terrorism.[39] The working group notes that coordination with regulators overseas, on issues such as addressing money laundering, terrorist financing or financial stability becomes easier where regulation of KYC norms is vigorous and in alignment with global best practices. Familiarity with regulatory objectives, where regulatory standards are in line with global regulatory practices, also allows global financial institutions to integrate control structures more easily and reduces frictions in investing.

The working group also notes that the three issues of enforcement – terrorism, tax evasion and blocking market manipulation – should be addressed in a nationality-neutral way. Enforcement authorities (the Home Ministry, the CBDT and SEBI) need to build sophisticated enforcement capabilities that are suited for a complex economy, and that are independent of capital flows management regulations. These agencies need to be consulted before the formulation of KYC norms so that these regulators concerns are addressed in the formation of these regulations. For example, members noted that the United States has a regime where qualified foreign institutional investors are required to agree to a regular information exchange protocol with the tax administrator in order to be allowed participate in U.S. financial markets and also to avoid higher withholding tax.

[39]The Central Government started a new system of KYC, implemented by the RBI, after the Prevention of Money Laundering Act, 2002 was passed by Parliament. *See*, DBOD.AML.BC.18/14.10.001/2002-03 dated 16-08-2002 (implementing the new KYC system). The RBI has subsequently passed a number of notifications on the subject placing additional responsibilities on Banks and Non-banking financial companies ("NBFCs"). (*See generally*, DBOD.NO.AML.BC.58/14.01.001.2004/05 dated 29-11-04, DNBS(PD). CC 126/03.10.042/ 2008-09, dated 05-08-08). Notifications for each year are consolidated into master circulars on KYC. (*See*, RBI/2009-10/73 DBOD.AML.BC.No.2/14.01.001/2009-10 dated 01-07-09).

5.2.4. *Country comparisons*

Looking at peer nations treatment of unlisted (and listed) equity, neither Brazil and South Africa, nor South Korea and Turkey fragmented markets by differentiating between different types of investors. Only India, of this peer group, imposes quantitative restrictions on foreign investment,[40] though reporting requirements in these nations change depending on the percentage of investment in a company held as equity by foreign investors.

Brazil, South Korea, South Africa and Turkey follow OECD practices of distinguishing portfolio and direct investment where, namely, investment between zero and ten percent in a listed company is considered portfolio investment and investment over this amount is considered direct. Investment in an unlisted company is considered direct investment. Notably, the primary material difference for investors in these nations whose investments cross the ten percent threshold is an increase in disclosure requirements, not the imposition of a different regulatory regime administered by separate regulators as with India's division of regulatory labour between RBI, SEBI and DIPP.[41]

5.3. Recommendations: A single window for portfolio investment regulations

5.3.1. *What is a Qualified Foreign Investor or QFI and why?*

The working group recommends the implementation of a Qualified Financial Investors or QFI model, where foreign investors, would be presented with a single window for registration and clearance of portfolio investment. (See Figure 5.1). In such a framework, qualified depository participants ("DPs"), with global presence through branch network or agency relationships would be legally responsible for enforcing OECD-standard KYC requirements. Such global DPs would have higher capital requirements and would need to pass a detailed fitness test administered by SEBI.

The QFI framework would cut across asset classes with no distinction made between investor classes. FIIs, FVCIs and NRIs would be abolished as an investor class.

Generally speaking, investment into listed or unlisted securities at a level below 10 percent of shares would be considered portfolio investment. This is the current limit for FIIs which presumably would be extended to QFIs. Investment above 10 percent would be considered FDI and would require compliance with existing FDI rules, regulations and procedures. This is the standard OECD distinction and practice as well of peer countries such as Brazil, South Korea, South Africa and Turkey which have comparably sized domestic markets and democratic governance.

All existing sectoral limits under FDI policy or other industry-specific regulation such as regulation of mutual funds or pensions, and takeover regulations under the Companies Act, would continue as before. Within the automatic route, there would be no distinction between FDI and portfolio investment. Consistent with Lahiri Committee recommendations, in areas where there are no separate ceilings by an Act of Parliament, QFI investment ceilings should be reckoned over and above prescribed FDI sectoral caps.

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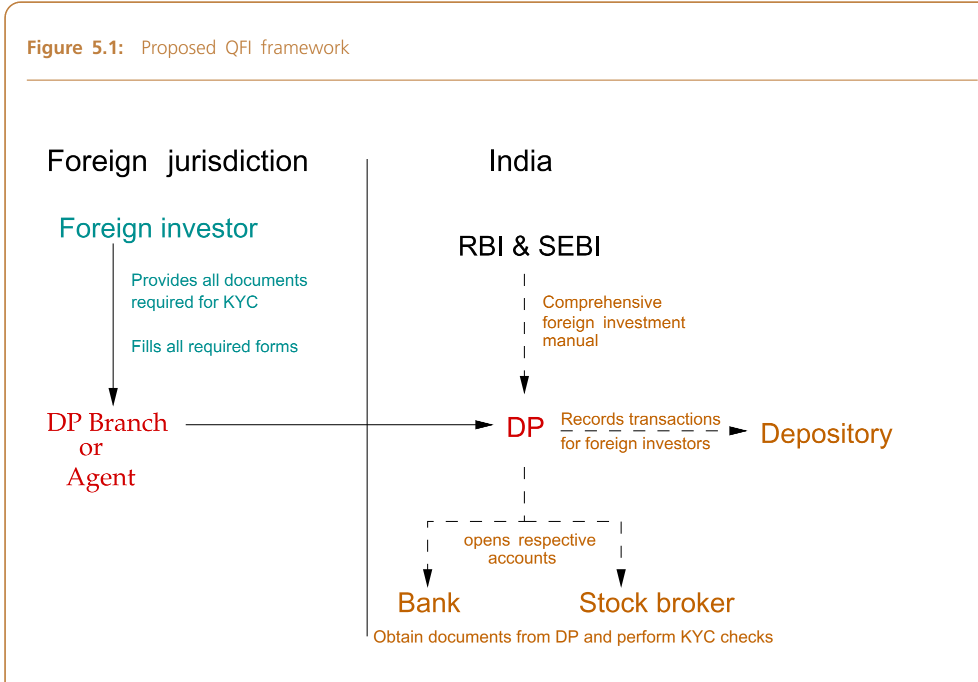
[40] The working group was not able to properly verify our conclusions about South Africa. Accordingly, our assessment of the legal regime for foreign investment in that country is provisional.

[41] International Capital and Exchange Market Regulation (2009)(Braz.), *available at* http://www.bcb.gov.br/?RMCCINORMSNORM; ECONOMICS INTELLIGENCE UNIT, COUNTRY FINANCE SOUTH KOREA(2009); Exchange Control Manual (2009)(S.Afr.), *available at* http://www.reservebank.co.za/internet/publication.nsf/WCEV/8B1C8768741BF40C42256C44003331A6/?opendocument; DEUTSCHE BANK, DEUTSCHE BANK MARKET GUIDE TURKEY(2009). Increased disclosure is required for reasons of monitoring corporate takeovers.

Figure 5.1: Proposed QFI framework



Operationalising this framework would require opening three accounts: a bank account, a DP account and a brokerage account.[42]

A QFI structure achieves three significant goals. First, it would separate regulation of cross-border capital flows from financial regulation. Seamless market entry and participation upon compliance with FATF standards of KYC are typically associated with regulatory systems with full capital account convertibility. Yet, this link is not a necessary one. Once capital flows management regulations are cleared, market participation of foreigners should be regulated in line with SEBI's regulation of domestic investors. The working group felt that such measures would decouple questions of capital flows management regulations from questions of achieving a safe and healthy secondary market. Market regulation, would then not discriminate between domestic and foreign players. This regime would not interfere with the Reserve Bank's ability to restrict or loosen capital flows into the country. The universe of investors now permitted under the current FII-NRI-FVCI framework would not change under a QFI regime. Members noted that currently, non-resident companies or non-resident individuals registering as sub-accounts of FIIs face fairly onerous qualifying conditions. Under a QFI regime, these companies and individuals would simply have to fulfill KYC requirements to invest as a QFI directly.

Regulation of capital flows for reasons of monetary policy or financial stability would just have to be stated more directly or explicitly rather than through the limitations imposed on multiple investment categories. Upon clearance of capital flows management regulations, the focus of regulation would on addressing the actions of any player whose actions threaten market integrity.

Second, this structure would consolidate and streamline India's regulation of capital flows. The working group feels that capital flows management regulations are bet-

[42]The working group notes that there are more detailed issues with the creation of QFI accounts that would have to be addressed in greater detail. As discussed in different contexts below, investment through a QFI account would have implications for FDI policy; FEMA 20 regulations would need to be rewritten. Also, to the extent the government is interested in monitoring information about, for example, capital flows by sectors, the operational details of these accounts would have to be thought through more extensively. Would statistics for inflows need to be computed taking net accretion in aggregate inflows in QFI accounts rather than filings with the RBI? More work needs to be done.

Box 5.1: How would QFI work for individual investors?

1. The foreign entity approaches the office/branch of a Depository Participant regulated by Indian authorities ("DP") or the DP's agent in his home country, to open a QFI account;
2. The proposed QFI fills up forms and deposits all documents to fulfill KYC rules and other sets of information that different authorities may choose to collect;
3. The proposed QFI fills up forms and applications to open the following (along with the requisite documents):
   - An account with a DP;
   - An account with a custodian;
   - A QFI account with a bank regulated by the RBI;
   - An account with a SEBI registered broker to carry out instructions;
4. The DP then takes the relevant documents and opens the accounts for the foreign entity on his behalf;
5. The foreign entity gets an unique number, perhaps a Personal Account Number or "PAN," which is kept by the DP which connects all the accounts opened by him and reports this number to SEBI, RBI, CBDT or any regulator as required;
6. The foreign entity is now ready to trade in the Indian Securities Market without ever setting foot in India.

ter operationalised by focusing on *asset classes* (i.e. rules for equity, debt and derivatives directly) rather than on *investment vehicles* (i.e. rules for FIIs, FVCIs or NRIs). Eliminating various existing sub-classifications and moving away from ad-hoc controls on investment would ease legal bottlenecks while preserving the central banks broad ability to regulate capital flows. Having a single window for portfolio investment regulations would offer a more clear investment regime, reduce uncertainty, compliance costs and the time taken to make investments considerably without in anyway altering domestic investment frameworks. The working group feels that a QFI framework strengthens prudential regulation by allowing the Reserve Bank to continue to limit investment into sectors (i.e. real estate or atomic energy) where foreign investment is viewed cautiously while limiting regulatory arbitrage facilitated by having multiple investment avenues to direct capital flows through. The working group also notes that our recommendations offer a more detailed elaboration of analyses and recommendations made by government committees before. The Tarapore Committee, in particular, has recommended that "all individual non-residents should be allowed to invest in the Indian stock market through SEBI registered entities including mutual funds and Portfolio Management Schemes who will be responsible for meeting KYC and FATF norms and that the money should come through bank accounts in India."[43]

Third, a QFI regime would offer more rigorous forms of registration and KYC practice. As with domestic investment, SEBI would not register individuals but would hold intermediaries responsible for performing certain functions. Instead of SEBI performing registration directly, responsibility would be given to a SEBI regulated entity supervised by the usual mechanisms of enforcement.

FII regulations are fifteen years old and predate international KYC standards. Indian regulators have significant experience monitoring foreign investment. Even so, or perhaps due to this experience, the working group expresses concern that the existing SEBI registration does not fully reflect international KYC standards. Multi-class

[43] Tarapore Committee Report, *supra* note 34 at 124, and at accompanying text.

Box 5.2: How would transactions be carried out?

1. A QFI makes a purchase order to its broker;
2. The broker/custodian carries out the order and credits the money from the account;
3. The custodian checks whether the purchase was within the limit for foreigners and then records the same;
4. The bank transfers money from the NRO account of the foreigner;
5. For sale the same is carried out and the money is deposited to the NRO account of the foreigner;
6. Whenever the foreigner wishes to withdraw the amount, the same is done after deduction of applicable taxes by the bank.

structures available in sub-accounts are opaque to regulators. Creating registration requirements in compliance with international anti-money laundering/Combating terrorist financing ("AML/CFT") best practices and the Prevention of Money Laundering Act ("PMLA") allows a means of monitoring capital movements – such as those that currently flow into participatory notes ("P-notes") – that is not available now and can only strengthen India's regulation of capital flows.

5.3.2. *KYC Norms*

As noted, rationalizing the structure of capital flows management regulations requires attention to KYC rules. Registration in and of itself does not constitute proper KYC practice. The working group came to a broader definition of KYC requirements than is usually understood which would combine current KYC rules, including adherence to the Prevention of Money Laundering Act and the rules and regulations made therein, as well as information required for the registration of a QFI by various regulators, i.e., RBI, SEBI and CBDT. (See Figure 5.2).

KYC standards meeting OECD or international standards of best practices are of crucial importance to the implementation of the QFI model. Proper KYC requires the provision of information about each transaction from source to completion. This includes determining the identity of a foreign investor, which would include corporate structures. This would also include establishing a system of investigation to track foreign individuals. Understood as such, KYC norms help establish the identity of investors without current regulatory hassles. KYC norms, as broadly understood here, also ensure that authorities have the means to address concerns regarding proceeds from criminal activity as well as tax and capital flows management regulations evasion and market integrity matters. This would address concerns related to monitoring capital flows related to drug trafficking, extortion, terrorism and money laundering as well as phenomena such as round-tripping, misinvoicing and under-invoicing.[44] Proper KYC requirements should also be clear and achievable without the requirement of further permissions. Prima facie, KYC norms as understood by this working group would require a lot of information to be provided at the time of registration.

[44] Different regimes require different kinds of data. For example, the tax system looks for proof of identity, creditworthiness and the genuineness of a transaction. SEBI currently does not use the language of conventionally understood KYC. SEBI uses criteria of "fit and proper" to ascertain identities. Members noted that while SEBI collects extensive amounts of information about investors, this should not be equated with or relied upon as a full KYC process.

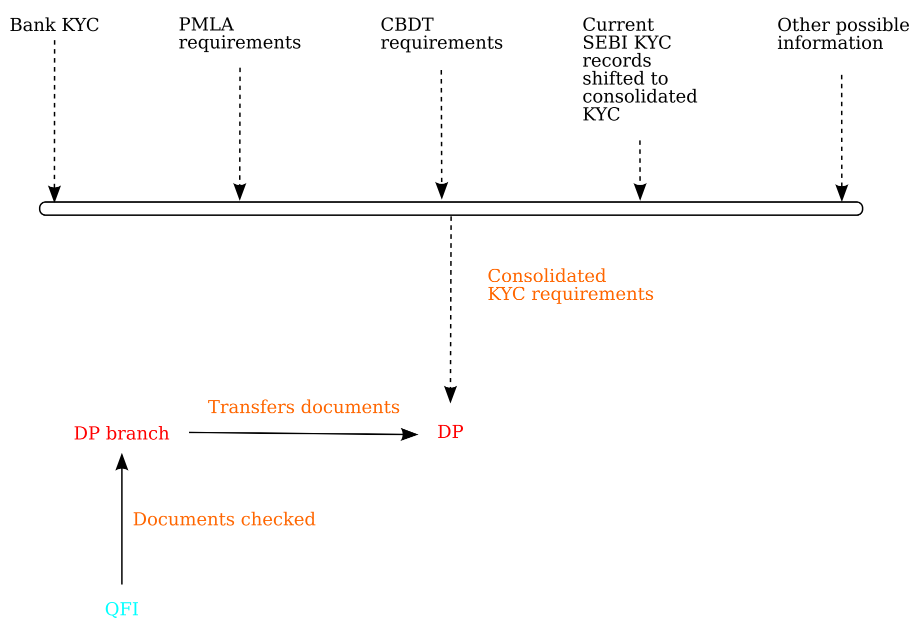
Box 5.3: Existing arrangements in lieu of KYC

The working group was particularly concerned that the SEBI registration process was being relied on as a de facto process of KYC fulfillment. At present SEBI collects information about FIIs, through a registration form required of applicants for FII status.[SEBI (Foreign Institutional Investors) Regulations, 1995 *at*, Form A] Information about sub-accounts is also collected through a form.(SEBI (Foreign Institutional Investors) Regulations, 1995 *at*, Form AA) Information collected by forms appear inconsistent. For example, while sub-accounts are required to disclose their tax jurisdictions, FIIs are not. There is a large amount of information collected about the nature of the FII or sub-account (such as whether the entity is a pension or mutual fund) that has no immediate nexus with questions of market integrity. In contrast, Indian investors do not have to disclose their objectives of investments, or have any objective in the first place, for making portfolio investments. Of course, when FIIs and sub-accounts open bank accounts, they provide KYC information to banks as normal customers.

Foreign Venture Capital Investors are required to provide a different set of information, namely the nature of funds and objectives, though not any information about the primary investors in that fund. (SEBI (Foreign Venture Capital Investors) Regulations, 2000 *at*, Form A).

Looking at FDI investments, Indian companies accepting investments from foreign investors are allowed to fill up a form on behalf of these investors and submit the same to RBI. (Foreign Exchange Management (Transfer or Issue of Security by a Person Resident outside of India) Regulations, 2000, Schedule 1, Paragraph 9 *read with* Annex B and C).

Figure 5.2: Proposed KYC framework



Still, proper KYC offers the means to address these important policy goals while limiting the creation of onerous burdens that limit financial development.

Prior to the September 11 attacks in the US, omnibus accounts were used as the basic channel for cross-border investment, an arrangement which would have made implementing the kind of KYC requirements we suggest impossible.[45] Tracking of

[45] Omnibus accounts are consolidated accounts that aggregate the demand for all clients of a given broker.

individual transactions under these conditions was impossible.[46] This working group notes that, in practice, individual KYC is superior to omnibus accounts in tracking money laundering and other criminal activity. Each individual client is registered and all transactions made by her/him can be tracked. Currently, international or OECD standards for KYC are quite rigorous. As noted earlier, the RBI recognizes and implements international KYC standards for banks.[47] KYC norms, as envisioned by the working group, would require the tracking of information about each transaction from source to completion by DPs. All regulators could use these systems to meet their regulatory objectives.

Members noted countervailing concerns that requiring extensive information at the point of entry could increase registration costs significantly. Some members also noted that requiring extensive information at the point of registration could confuse regulation of entry with other regulatory objectives[48]

Nonetheless, the working group concluded that the extent of information provided under KYC systems meeting standards of international best practices offers stricter, more stable means of addressing market integrity and criminal law standards than before. The working group strongly feels that strengthening KYC norms will allow India to comply with FATF regulations, ultimately benefit all investors and increase general confidence in markets.

5.3.3. *P-notes*

Participatory notes are of concern for reasons of volatility and terrorist financing. The working group strongly feels that streamlining registration processes with international standards could also remove the incentives to participate in markets such as those for participatory notes.

With regard to addressing volatility, the working group suggests that regulators continue to build systems and practices and deepen and broaden markets which can withstand volatility. Indeed, the Government has put in place systems and practices to promote a safe, transparent and efficient market and to protect market integrity. The systems instituted include advanced risk management mechanisms comprising online monitoring and surveillance, various limits on positions, margin requirements, circuit filters, etc. Measures taken to broaden and deepen markets include: screen based trading system, dematerialisation of securities, corporatisation and demutualization of exchanges, settlement through clearing corporation, trading in of derivatives and more.

With regard to addressing terrorist financing, the working group notes that investment in the stock market by individual investors as well as by institutional investors takes place by the use of funds channeled through bank accounts. Banks maintain details of each account holder in accordance with the Know Your Customer norms which have been put in place by the banking regulator.

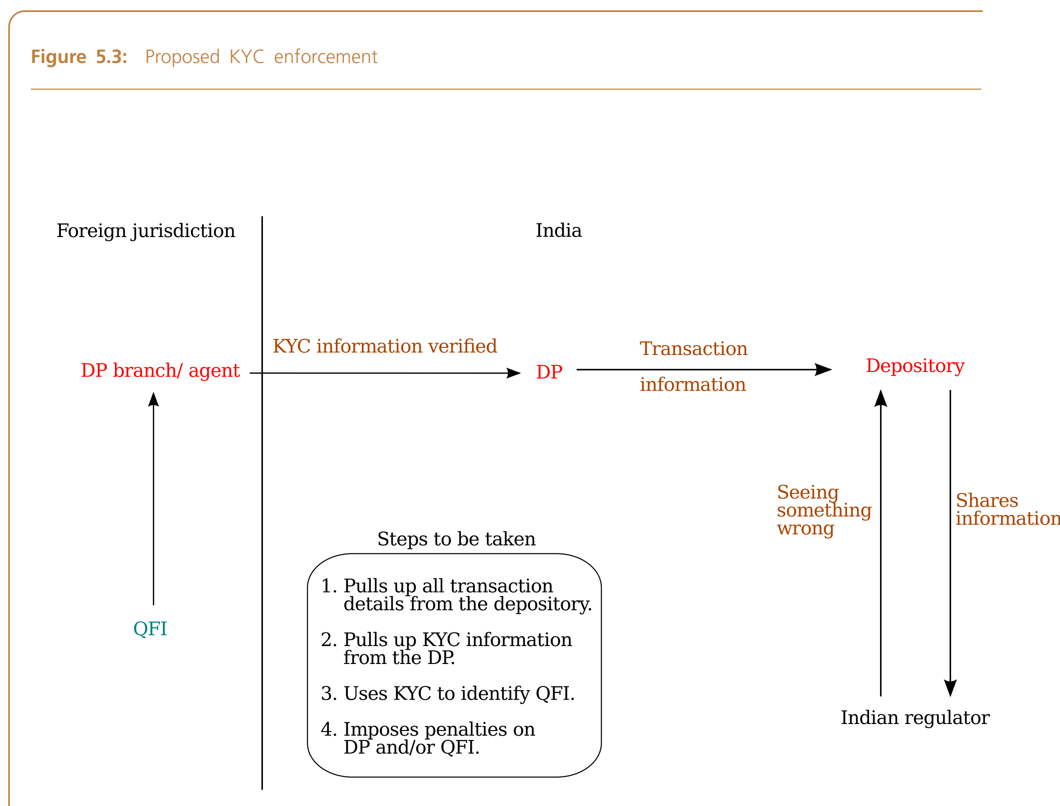
P-Note issuing entities are large sized reputed financial institutions with presence in a host of markets globally and operating in multiple capacities. These entities issue P-Notes directly or indirectly through global financial centers such as London,

[46]For example, under this system, a broker in India would place an order for securities in a foreign jurisdiction on behalf of all her clients. Similarly, overseas brokers would place orders for Indian securities on behalf of their clients through the same Indian broker. Under these arrangements, tracking which security belongs to which individual client while passing through the hands of these brokers would not really be possible.

[47]*See, supra* note 39 and accompanying text.

[48]One member noted, for example, that the CBDT should address concerns with round-tripping through the procedures laid out in the Income Tax Act, not registration. However, fulfillment of KYC norms involve only the provision of information. CBDT could use information gained through the KYC process to proceed down the avenues created by the IT Act.

Figure 5.3: Proposed KYC enforcement



Hong Kong, Singapore etc which have Anti-Money Laundering (AML) and Combating Financing of Terrorism (CFT) regulations in place. Additionally, FII investments into India continue to be subject to Indian Anti-Money Laundering and KYC norms.

In any case, the working group feels that certainly greater onshore participation facilitates financial stability through the greater ability of regulators to supervise market practices. The working group notes further that policy focus should examine the incentives, like ad hoc registration systems, that lead to the use of instruments like participatory notes. For example, under current SEBI Regulations, individual investors need to have a net worth of not less than fifty million US dollars to register as a sub-account of an FII.[49] There are, no doubt, investors of net worth less than this amount who would legitimately be interested in investing in India. Currently, P-notes may only be issued to counterparties that fulfill SEBI specified requirements. However, opening portfolio investment more broadly through the QFI framework to individuals with less than fifty million US dollars would increase levels of investment while reducing the incentive to participate in P-notes.

Still, the working group feels that there may be other legitimate reasons for investing in derivatives. Many investors may want to structure sector baskets covering stocks in many different markets or may not want to run the direct operational risk of stock trading in markets directly. Furthermore, there may be little correlation between the amount of offshore derivative instruments and inflows and outflows from Indian securities markets because hedging and risk management tools have advanced well beyond simple delta one products.

Additionally, there may always be a residual P-note market outside the country. The Tarapore Committee has noted that "it is also not possible to prevent trading in PNs (participatory notes)" to the extent that Indian regulators do not have the

[49] SEBI FII regulations, *supra* note 3, at Regulations 13(1)(a)(iv) read with Explanation I, paragraph B.

jurisdiction to restrain foreign entities from issuing such notes on the strength of securities held by them.[50] The working group notes that SEBI should have the final right to demand details about the end investor in cases of needed investigations.

5.3.4. *Overlap between FDI and portfolio investment policy*

Implementing a QFI framework does require a few caveats. Attending to the overlaps between direct investment and capital flows management policy is a complex endeavour. We identify a few areas that will need to be considered at greater length.

The working group notes that there are sectors where FDI and capital flows management policy will overlap. Foreign direct investment policy is beyond the mandate of this group, yet attending to investment rules in areas implicated by both FDI and portfolio investment will play a crucial role in determining whether our proposal to create a single window for portfolio investment regulations rationalizes investment frameworks in the ways intended.

For example, there are a few industrial sectors, like asset reconstruction, real estate, private sector banking, FM radio, commodity exchanges and more, where FDI policy and portfolio investment intertwine, and where harmonizing a QFI framework with existing FDI policy could have unintended consequences not contemplated by this working group. Table 5.2 presents examples of a number of these sectors. However, the working group also notes that this would not be difficult once the definition of portfolio investments are clarified.

To use another example, the consolidated FDI Policy released on March 31, 2010, inter alia indicates, vide clause 5.31.4 thereof, that a SEBI registered foreign venture capital investor can invest in a domestic venture fund ("DVF") (registered under the SEBI (Venture Capital Fund) Regulations, 1996 and set up as a trust registered under the Indian Trust Act, 1882) upon obtaining a prior government approval. Both the FVCI and the DVF are regulated by SEBI. Several domestic venture capital funds use a 'unified' structure for pooling funds from domestic and international investors. The new policy could restrict the structural alternatives available for private equity funds. Here, the working group recommends that the Government amend the consolidated FDI Policy to exempt SEBI registered QFIs from seeking approval of the Government prior to investing in a DVF incorporated as a trust.

Examining these matters at a broader level of generality, the working group notes that these matters have a somewhat long history. The Lahiri Committee has offered a detailed review of the evolution of FII policy.[51] The Lahiri Committee report states that there is a clear conceptual distinction between portfolio investment and FDI.[52] FIIs are presumed to not be interested in management control,[53] whereas FDI is considered to be "that category of international investment that reflects the objective of obtaining a lasting interest by a resident entity in one economy in an enterprise resident in another."[54] Generally speaking, investment into listed or unlisted securities at a level below 10 percent of shares would be considered portfolio investment. This is the current limit for FIIs which presumably would be extended to QFIs. Any particular sectoral limit set by Parliament would continue. Investment above 10 percent would be considered FDI and would require compliance with existing FDI rules, regulations and procedures.

[50] Tarapore Committee report, *supra* note 34, at 143.
[51] Government of India, Ministry of Finance, Report of the Committee on Liberalisation of Foreign Institutional Investment (2004)[hereinafter Lahiri Committee I].
[52] *Id.* at 19.
[53] *Id.*
[54] *Id.* at 45.

Table 5.2: FDI policy and FII investments

	Sector/Activity	FDI Cap / Equity	Entry Route
1	**Asset Reconstruction**	49% paid up capital.	Only after RBI permission. FIIs are not allowed to invest. Investment must be in nature of FDI.
2	**Banking - Private sector**	74% (FDI+FII) Within this limit, FII investment not to exceed 49%.	Automatic up to 49%. From 49% to 74% with government approval
3	**Broadcasting**		
a.	FM Radio	FDI +FII investment up to 20%	FIPB
b.	Cable network	49% (FDI+FII)	FIPB
c.	Direct-To-Home	49% (FDI+FII)	FIPB
d.	Setting up hardware facilities such as up-linking, HUB, etc.	49% (FDI+FII)	FIPB
e.	Up-linking a News & Current Affairs TV Channel	26% (FDI+FII)	FIPB
4	**Commodity Exchanges**	49% (FDI+FII) FDI – 26% FII – 23%. FII purchase is restricted to secondary market only.	FIPB
5	**Infrastructure companies in securities markets namely, Stock Exchanges, Depositories and Clearing Corporations**	49% (FDI+FII) FDI – 26% FII – 23%	FIPB
6	**Credit Information Companies ("CIC")**	49% (FDI+FII) Within this limit, FII investment not to exceed 24%.	FIPB
7	**Print Media**		
a.	Publishing of newspaper and periodicals dealing with news and current affairs	26% NRIs/ PIOs/ FII	FIPB
b.	Publications of Indian editions of foreign magazines dealing with news and current affairs	Foreign investment including FDI and investment by NRI/ PIOs/ FII up to 26% is permitted.	FIPB
8	**Telecommunication**		
a.	Basic and cellular, Unified Access Services, National/ International Long Distance, V-Sat, Public Mobile Radio Trunked Services ("PMRTS"), Global Mobile Personal Communications Services ("GMPCS") and other value added telecom services	74% (including FDI, FII, NRI, FCCBs, ADRs, GDRs, convertible preference shares, and proportionate foreign equity in Indian promoters/ Investing Company)	Automatic up to 49%. Beyond 49%- FIPB approval.

As discussed earlier, peer nations with comparably sized domestic markets and democratic practices, namely, Brazil, South Korea, South Africa and Turkey, follow OECD practices of distinguishing portfolio and direct investment where, investment between zero and ten percent in a listed company is considered portfolio investment and investment over this amount is considered direct. Investment in an unlisted company is considered direct investment. Notably, the primary material difference for investors in these nations whose investments cross the ten percent threshold is an increase in disclosure requirements, not the imposition of a different regulatory regime administered by separate regulators as with India's division of regulatory labour between RBI, SEBI and DIPP.

With regard to the regulatory treatment and distinction between FDI policy and FII investment, the Lahiri Committee recommended that "FII investment ceilings, if

any, may be reckoned over and above prescribed FDI sectoral caps."[55] Table 5.2 describes the current legal treatment of the conjunction between FDI and FII investment policy. Namely, for certain specified sectors, FDI and FII limits are combined or cumulative. In certain sectors, FIIs face a lower limit within a higher FDI limit. In one sector, asset reconstruction, FII investment is banned. This working group reiterates what we perceive to be the intent of the Lahiri Committee recommendation that in these cases, QFI investment ceilings be reckoned over and above prescribed FDI sectoral caps.

5.3.5. *Implications of doing away with FVCI and NRI categories*

As stated earlier, the QFI framework would cut across asset classes with no distinction made between investor classes. FIIs, FVCIs and NRIs would be abolished as an investor class. All regulated investment under FDI policy or other sectoral regulation such as regulation of mutual funds or pensions and takeover regulations under the Companies Act, would continue as before. Within the automatic route, there would be no distinction between FDI and portfolio investment.

The working group notes that there are important areas where regulations tailored to a particular type of institution, like venture capital firms, would ostensibly be eliminated. The implications of these decisions bear review. One example involves negative lists. FEMA specifies a negative list for FDI investment[56] and FVCI investments as discussed above.[57] While the limits specified by Parliament under FEMA would continue under the QFI framework–investment in atomic energy, for example, whether over or below 10 percent would be disallowed–SEBI's, negative list, admittedly already small, would be removed. At minimum, the working group strongly urges the government to ensure that a situation analogous to when venture capital regulations were effectively restricted to 9 sectors referenced in the Income Tax Act is not repeated.[58]

A second example involves FVCIs and the QFI framework. The working group notes that the existing exemption for FVCIs from regulations with regard to following pricing guidelines as well as lock-in requirements at the time of initial public offerings to QFIs would be removed.[59] The working group notes that freedom from pricing guidelines and lock-in requirements are important benefits.[60] Nonetheless, the working group feels that the impact of dispensing with these benefits would be limited to the extent that registered FVCIs (as a formal legal category of investors) appear to contribute a small proportion of total investment. More importantly, the working group believes that the benefits to all foreign investors of a simplified investment framework in greater clarity and reduced transaction costs far outweighs the loss of these discrete benefits. Of course, venture capital firms would be free to invest

[55] *Id.* at paragraph 52A(i); Report of the Expert Group on Encouraging FII Flows and Checking the Vulnerability of Capital Markets to Speculative Flows 163 (2005) [hereinafter Lahiri Committee II].

[56] FEMA 20, *supra* note 3, Regulation 5(1), Schedule 1, paragraph 2 and Annexure A. (Prohibiting direct investment in retail trading, atomic energy, the lottery business, gambling and betting, housing and real estate and agriculture with certain exceptions.)

[57] SEBI (Foreign Venture Capital Investors) Regulations, 2000 *supra*, note 18 at Regulation 2(j), Third Schedule. (Prohibiting FVCI investment in non-banking financial services, gold financing, activities not permitted under the Industrial Policy of the Government of India and any other activity which may be specified by SEBI).

[58] *See, supra* note 24 and accompanying text.

[59] *See*, *supra* note 22 and accompanying text.

[60] From a commercial perspective, the non-applicability of pricing guidelines may facilitate investments by venture capital firms investing through the QFI route to the extent that this would provide greater flexibility in structuring terms of investments. Venture capital firms as a category of investors are more likely to implement structured investments. Further, venture capital investments through the QFI route will likely be concentrated in unlisted companies with an exit secured through a public listing; relief from lock-ins would also be a benefit for this category of investors.

under the rules of the QFI and FDI regimes. Existing FVCI investments should also be grandfathered to avoid business discontinuity for firms currently registered as FVCIs.

With regard to NRIs, the framework for NRI investments reflects historical decisions to make initial openings in the Indian economy through this avenue. As discussed earlier, investment benefits to NRIs have been largely bypassed by benefits granted to FIIs. Nonetheless, certain benefits, such as that of making specified investments without limit on a repatriation basis, would disappear under a QFI regime. The working group notes that, in practice, NRI investors face difficulties participating in investment funds with FII licenses because the differential requirements for NRIs and FIIs require the creation of complex accounting structures to monitor funds that disincentivises acceptance of NRI capital. While NRIs are formally advantaged in comparison to foreign individuals (who must register or invest through FIIs), we suggest that the loss of limited benefits to NRIs under existing law would be more than made up by the relative lack of restrictions, clarity and ability to invest on par with other foreign investors offered by our QFI system.

5.3.6. *Required legal changes*

What major legal changes would be needed to operationalise the major recommendation of this section, a QFI framework? The working group feels that the measures involved can be achieved through changes in regulation and do not require modifications of governing acts. The changes are:

1. QFI
   (a) SEBI FVCI and FII regulations would be replaced by a new QFI regulation. Such regulation would also grand-father existing FVCIs;
   (b) FEMA (Transfer or Issue of Security by a Person Resident Outside India) Regulations, notably Regulation 5 and attendant schedules would have to restate permissible caps and investment levels, now unified across asset classes;
   (c) Schedules specifying permitted investments by FIIs, FVCIs and NRIs would ostensibly be replaced by a new schedule for QFIs.
2. Depository Participants
   (a) First, enforcement of contracts between depository participants and investors should be clarified. In particular, international dispute settlement mechanisms should be established;
   (b) SEBI (Depositories and Participants) Regulations, 1996 would have to be amended to allow DPs to set up offshore branches;
   (c) FEMA (Transfer or Issue of Any Foreign Security) Regulations need to be amended to allow setting up of DPs abroad;
   (d) SEBI (Stock Broker and Sub-Broker) Regulations, 1992 would have to be changed to allow stock brokers to register foreign investors as clients with SEBI;
   (e) Criteria for filtering DPs who could be entrusted with the task of registering QFIs would have to be promulgated.
3. KYC
   (a) KYC guidelines for depository participants would have to be adopted and dovetailed with AML-CFT frameworks including those for reporting suspicious transactions ("Suspicious Transaction Reports" or "STRs"). Issues of responsibility for analyzing and taking action on STRs would have to be clarified and responsibilities assigned;

(b) DPs would report KYC information on behalf of clients investing in unlisted equity directly to the RBI. The RBI, pursuant to Foreign Exchange Management (Deposit) Regulations, 2000, Regulation 5, Schedule 3 would also have to give approval for the opening of limited purpose accounts for securities transactions.

4. Miscellaneous

(a) Closely review the implications of excluding regulation tailored to fit specific classes of investors like NRIs and FVCIs;

(b) Scrutinize areas where FDI and portfolio investment rules overlap;

(c) Consistent with Lahiri Committee recommendations, in areas where there are no separate ceilings by an Act of Parliament, QFI investment ceilings should be reckoned over and above prescribed FDI sectoral caps;

(d) The language of FEMA (Transfer or Issue of any Foreign Security) Regulations, particularly regulations 6C and 7 would have to be consolidated to address investment by mutual funds and other financial services firms;

(e) With regard to outflows, the Master Circular on Miscellaneous Remittances from India would have to be modified to permit banks to provide credit facilities to individuals once appropriate consumer protection standards are notified;

(f) Regulations permitting investment in foreign securities, presumably along the lines suggested by IDR policy, would also need to be promulgated.

5.4. Annexure

5.4.1. *Capital flows management regulations: Listed equity*

Inflows	FII	NRI	CORPORATES	INDIVIDUAL	VENTURE CAPITAL
Equity	4	4	1	1	3
Mutual Funds	4	5	1	1	1

Outflows	INDIVIDUAL	MUTUAL FUNDS	BANKS	PENSION FUNDS	INSURANCE FUNDS	CORPORATES
IDR	4	4	4	4	4	1
ADR/GDR	2	2	1	1	1	1
Equity	2	2	1	1	1	1
Mutual Funds	2	2	1	1	1	1

KEY	Complete Ban				Fully Open
	1	2	3	4	5

5.4.2. *Capital flows management regulations: Unlisted equity*

Inflows	FII	NRI	VENTURE CAPITAL	PE
Pure Equity	**2**	**4**	**3**	**1**

Outflows	INDIVIDUAL	MUTUAL FUNDS	BANKS	PENSION FUNDS	INSURANCE FUNDS	CORPORATES	VENTURE CAPITAL
Pure Equity	**2**	**2**	**1**	**1**	**1**	**1**	**2**

KEY	Complete Ban				Fully Open
	1	**2**	**3**	**4**	**5**

5.4.3. *BSST countries: Equity*

		India		Brazil		South Korea		South Africa		Turkey	
		Inflows	Outflows	Inflows	Outflows	Inflows	Outflows	Inflows	Outflows	Inflows	Outflows
Investor type differentiation		**1**	**1**	**0**	**1**	**0**	**0**	**0**	**0**	**0**	**0**
Quantitative restrictions	Level	**0**	**1**	**0**	**0**	**0**	**0**	**0**	**1**	**0**	**0**
	Percentage	**1**	**0**	**1**	**0**	**0**	**0**	**0**	**1**	**0**	**0**
Taxation measures		**1**	**1**	**0**	**0**	**0**	**0**	**0**	**0**	**0**	**0**

Note: 1 = Yes, 0 = No.

CHAPTER 6

Equity and outflows

The working group felt that policy consideration of outflows is important for reducing risk in India. Investing abroad offers Indian investors, all residents of India, reduced risk through diversification of holdings, though such investment is predicated upon appropriately strong consumer protection rules. The working group also compared investment in foreign securities with parameters set in IDR regulations.

The first section of this chapter reviews the existing law regarding investment by Indian residents abroad. This section is broken into subsections presenting the law regarding outflows into, respectively, listed equity and unlisted equity. Subsequent sections present our analysis and recommendations.

6.1. Current law

6.1.1. *Outflows into listed equity*

Looking at outflows into listed equity, various forms of outbound investments are available to individuals in India. Individuals are allowed to invest in foreign shares and foreign mutual funds up to US $200,000 under the Liberalised (sic) Remittance Scheme ("LRS") though banks are not allowed to provide credit facilities to facilitate these transactions.[1] Individuals are also permitted to invest in Indian Depository Receipts ("IDR") of foreign companies but are subject to a number of restrictions ranging from restricted availability of shares, lock-in periods before redemption and forced sales.[2]

[1]FEMA Master Circular No. 5/2009-10, (Master Circular on Miscellaneous Remittances from India-Facilities for Residents) Dated 1-7-2009, [hereinafter FEMA Liberalized Remittance Scheme] Issued by Foreign Exchange Department, RBI at Paragraph 13.5 (specifically authorizing investment in listed or unlisted shares under the scheme) and Paragraph 13.9 (authorizing individual investment in foreign mutual funds) and Paragraph 13.13 (stating that banks "should not extend any kind of credit facilities to resident individuals to facilitate remittances under this scheme.)"

[2]SEBI (Issue of Capital and Disclosure Regulations), 2009, Regulation 98(d) and (e) (Regarding limited availability, stipulating that at least 50 percent of an IDR issue should be allotted to qualified institutional buyers on a proportionate basis, as prescribed, and that the remaining 50 percent may be allocated among the categories of non-institutional buyers and retail individual investors at the discretion of the issuer and in a manner disclosed in the issues prospectus); RBI/2009-10/106 A.P. (DIR Series) Circular No. 5, July 22, 2009. (Regarding lock-in period and forced sale, requiring that IDRs shall not be redeemable into underlying equity shares before the expiry of one year period from the date of issue of the IDRs, and that persons resident in India, including resident individuals, are allowed to hold underlying shares only for the purpose of sale within a period of 30 days from the date of conversion of the IDRs into underlying shares).

Domestic mutual funds are also allowed specified investments in foreign stores of capital. Domestic mutuals are specifically allowed to invest in American Depository Receipts ("ADRs") or Global Depository Receipts ("GDRs") issued by Indian or foreign companies up to a maximum investment of US $300 million per mutual fund and an aggregate limit for all mutual funds of US $7 billion.[3] Such mutuals are also allowed to invest directly in equity of overseas companies listed on recognized foreign stock exchanges subject to the same ceilings.[4] These funds are also allowed to invest in foreign mutual funds or unit trusts registered with overseas regulators under specified conditions.[5]

Bank investment in foreign listed equity appears to be quite restricted. Bank investment in foreign equity, ADRs or GDRs and mutual funds are banned. However, strategic investment by banks in foreign equity may be permitted by the RBI.

Domestic pension fund investments in outflows are banned. As discussed earlier, the Pension Fund Regulatory Development Authority Bill has lapsed and the PFRDA operates pursuant to executive order [6]. Preliminary draft regulations would explicitly limit pension fund purchases of debt securities to those issued by the Government of India and certain corporations incorporated in India.[7] As such, while investments into IDRs would ostensibly be permitted, pension fund investment into foreign equity, ADRs or GDRs or mutual funds would be banned. As noted above, two-way fungibility for IDR investments are, however, not allowed. [8]

Investments by insurance firms are likely restricted on similar lines as would be the case with pension funds. As discussed above, insurance funds too, are limited to a specified schedule of investments that include Central and State government securities as well as infrastructure and social sector investment. IRDA Regulations do include a category of "other" investment governed by a list of exposure or prudential norms.[9] Investment in foreign securities is not explicitly authorized. Ostensibly a fund could invest an appropriate percentage of their funds in foreign securities pursuant to this schedule, though the intent and authority for this position appears speculative.

Corporates are not permitted to invest into listed equity as part of their treasury management operations but can invest into listed equity, within limits, through the overseas direct investment ("ODI") route. [10]

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[3] SEBI Circular No. IMD/CIR No.2/122577/08 (Overseas Investment by Mutual Funds), dated 8-4-2008 at Paragraph 2.

[4] *Id.* at Paragraph 2(ii).

[5] *Id.* at Paragraph 2(x) (noting that domestic mutuals are allowed to invest in overseas mutual funds investing in (a) aforesaid securities, (b) Real Estate Investment Trusts (REITs) listed in recognized stock exchanges overseas, or (c) unlisted overseas securities (not exceeding 10 per cent of their net assets)). Aforesaid securities would ostensibly refer to the list of permissible investments for mutual funds listed in Paragraph 2 broadly, which includes ADRs or GDRs issued by Indian or foreign companies, equity of overseas companies listed on recognized stock exchanges overseas and initial and follow on public offerings for listing at recognized stock exchanges overseas.

[6] Ministry of Finance, Department of Financial Services Resolution F.No. 1(6)2007-PR , The Gazette of India, Extraordinary, Part I, Section I, November 14th 2008

[7] Pension Fund Regulatory and Development Authority (Registration of Intermediaries) Regulations, 200_, Preliminary Draft Regulations (September 2005) [hereinafter Draft PFRDA Regulations].

[8] *See*, RBI/2009-10/106 A.P. (DIR Series) Circular No. 05, dated July 22, 2009, *supra* note 2.

[9] Insurance Regulatory and Development Authority (Investment) Regulations, 2000 [hereinafter IRDA Investment Regulations].

[10] Foreign Exchange Management (Transfer or Issue of Any Foreign Security) Regulations, 2004, [hereinafter FEMA Transfer or Issue of Any Foreign Security Regulations] at Regulations 5 and 6. ODI is more formally labeled as "Direct Investment Outside India" in regulations. Listed Indian companies are permitted to implement portfolio investments up to 50 percent of their net worth as on the date of the last audited balance sheet in shares, bonds or fixed income securities, rated not below investment grade by accredited or registered credit rating agencies, issued by listed overseas companies.

6.1.2. *Outflows into unlisted equity*

Looking at outflows into unlisted equity, individuals are free to invest in unlisted equity up to the US $200,000 limit under the Liberalised Remittance Scheme, though operational bottlenecks limit these benefits.[11] In particular, pooling of investments are disallowed though pooling of family members is permitted, advertising and marketing are banned and remittances to certain jurisdictions are banned.[12] Domestic mutual funds are not permitted to invest directly in unlisted equity, but may invest in regulated foreign mutuals who invest 10 percent or less of their net assets in unlisted securities.[13]

Domestic venture capital funds may invest in unlisted equity overseas, though investment may only be in companies "which have an Indian connection," and where such investments are no more than 10 percent of the investible funds of the venture capital fund.[14] Furthermore, this investment should be within the US$500 million ceiling for domestic venture capital funds.

Pension and insurance funds do not have the express authority to invest in unlisted equity overseas.[15]

Indian company investment in unlisted equity abroad would ostensibly be governed under the norms for direct investment. FEMA Regulations authorize Indian companies, including Indian financial services firms, to invest in joint ventures or wholly owned subsidiaries abroad.[16] However, financial services firms require prior RBI approval for ODI.

6.2. Analysis

Under the Liberalized Remittance Scheme, residents in India are allowed to remit up to US $200,000 overseas.[17] Currently, entities, whether foreign or Indian, that offer overseas investment products to residents do not have a regulatory framework to offer and market investment avenues.[18] The working group noted that lack of

[11] FEMA Liberalized Remittance Scheme, *supra* note 1, at A13, 13.4 (Prohibiting remittances for margins or margin calls to overseas exchanges or counterparties.)

[12] *Id.*

[13] SEBI (Overseas Investment by Mutual Funds) IMD/CIR No. 7/104753/07, dated 26-9-2007, Paragraph 2(x).

[14] SEBI Circular No. VCR/Cir. No.1/98645/2007, dated 9-8-2007, at Paragraph 3(ii).

[15] Pension Fund Regulatory and Development Authority (Registration of Intermediaries) Regulations, 200_, Draft PFRDA Regulations (September 2005), Regulation 46 & 55 (Stating that no investments may be made except in publicly traded debt securities issued by the Government of India, publicly traded debt securities of corporations incorporated in India that are regularly rated as investment grade by at least two rating agencies and loans of microfinance institutions established in India and guaranteed by the RBI and equity shares of corporations listed on exchanges in India regulated by SEBI that are included in an index approved by the authority); IRDA Investment Regulations, at Regulation 4. (Itemizing the specifically named investments and percentage limits that insurance funds may invest into). To the extent that pension and insurance funds are only allowed to invest in specified areas, and to the extent that unlisted equity abroad is not one of these areas, by construction, these institutions would not have the authority to invest in such securities overseas.

[16] FEMA Transfer or Issue of Any Foreign Security Regulations, *supra* note 10, at Regulations 6 and 7; FEMA Master Circular No. 1/2008-09, (Master Circular on Direct Investment by Residents in Joint Venture (JV)/Wholly Owned Subsidiary (WOS) Abroad), Dated 1-7-2008, Issued by Foreign Exchange Department, RBI at B.2(1) and (2) (Allowing investment in unincorporated entities overseas in the oil sector by certain entities without limit, and for other Indian companies up to 400 percent of their net worth).

[17] FEMA Liberalized Remittance Scheme, *supra* note 1.

[18] *Id.* at paragraph 13.3. By its circular dated March 18, 2004, the RBI advised that banks should not solicit deposits or market any mutual funds without the prior approval of the RBI. (*See*, RBI/2004/105 A.P. (DIR Series) Circular No. 80, March 18, 2004). Accordingly, the RBI has since approved the requests of certain banks to solicit deposits for their branches overseas subject to compliance with certain minimum disclosure requirements. In addition, the RBI has also issued instructions to these banks prescribing a monetary limit and a reporting framework as well as a provision for seeking renewal of permission. By a

development of avenues to direct permitted outflows under the LRS route is related to concerns about consumer protection. Worries about the lack of legal guidance for solicitations to invest abroad, at least those made on Indian soil, have impeded the creation of frameworks for Indian residents to diversify into a broader range of investments outside India.

The first Indian Depository Receipt, by Standard Chartered, is a milestone in the history of Indian finance. While the IDR issue has been successful, future bottlenecks could involve concerns with domestic financial regulation; for example, the Securities Transaction Tax. Problems with two-way fungibility for IDR investments and forced sales for individuals investing into IDRs are two additional obstacles to further success in building an ecosystem for depository receipts in India.

6.3. Recommendations

The working group feels that investing and trading in financial instruments overseas could expose Indian investors to risks stemming from lack of transparency and fairness. As such, the working group recommends that all entities structuring and offering securities market-related products in the overseas market, who offer these markets to residents in India, should register with SEBI and fully disclose all promotional materials, including product literature, advertisements, brochures etc. In accordance with current practice, SEBI should simply provide comments and neither approve nor disapprove given products, though SEBI could still reserve the right to ask that a given product be removed from Indian markets. These proposed guidelines would not be applicable to Indian residents investing in domestic funds which in turn invest abroad. These guidelines would not apply to those who do not carry out any activities within the territory of India. Plain vanilla investment products like bank deposits that do not involve exposure to securities would not be governed by these proposed guidelines. Applicants should also be duly regulated and authorised to offer such products by the securities market regulator in its home jurisdiction as specified by SEBI. A few further questions would also need to be clarified by SEBI. What would be the mechanism by which the board ensures that the scheme operates in the manner intended? Would SEBI rely on the institution of complaints or would the board actually seek details regarding performance to ensure that an entities proceed as declared? Would these requirements apply for each scheme or apply entity-wide?

letter dated August 3, 2004, the RBI advised SEBI to take appropriate action with regard to mutual funds and other securities market products to protect the interest of investors. The Reserve Bank also advised SEBI to consider issuing a press release to ensure that no entity markets any scheme covering securities markets products without specific approval of SEBI.

CHAPTER 7

Debt

In thinking about capital flows management and debt flows, the working group focused on issues of currency mismatch and institutional development. Specifically, the group discussed at great length the role of foreign currency denominated debt creating vulnerability in the economy through the process of currency mismatch and exchange rate risk, a phenomena labelled in economic policy literature as 'original sin'. The group also examined the reasons incentivising Indian corporate borrowing in foreign currency including the role of quantitative restrictions and the lack of institutional development of the corporate bond market.

The initial sections of this chapter provide background. The first section provides information about the depth of the government securities and corporate bond markets as well as comparisons with peer countries. The subsequent section reviews the law regulating these markets by inflows and outflows, and with regard to institutional and individual actors such as FIIs, domestic corporates, banks, mutuals, pension and insurance funds, NRIs, foreign individuals and domestic residents.

The next five sections lay out the working group's main areas of focus, sequentially. The matters considered are those of exchange rate risk, the impact of quantitative restrictions, questions of institutional development, the role of the QFI framework to debt and outflows. A final section will present the major legal changes required to operationalise our recommendations.

7.1. Context

A vibrant government securities market is important to provide the government low-cost financing.[1] A deep government securities market across all maturities would provide benchmarks for pricing corporate debt and various kinds of hedging instruments. Currently, a considerable proportion of debt financing is taking place through forcing banks to hold its debt through statutory requirements.[2]

For various, much-discussed reasons, the corporate bond market is moribund.[3]

[1] Planning Commission, Government of India, A Hundred Small Steps: Report of the Committee on Financial Sector Reforms, 104 (2009).

[2] *Id.*

[3] *Id.* at p. 117 (finding that most large issuers are quasi-government that there is very little high yield issuance, and spreads between sovereign debt, AAA debt and high yield debt are high in comparison to other markets, that very few papers trade on a regular basis, that trading in most papers dries up after the first few days of issuance, during which the larger players retail the bonds they have picked up to smaller financial institutions and that most trading is between financial institutions).

Corporate bonds accounted for only 3.2 percent of GDP versus 108 percent for equity. There were only Rs.2 trillion of issuances in the corporate bond market in 2008.[4] The lack of a corporate debt market limits the financing available for India's corporate and development needs.

Looking at peer nations, neither Brazil, South Africa, South Korea or Turkey regulate their government and corporate bond markets differentially. Brazil, South Korea and Turkey do not impose quantitative restrictions on debt investment while South Africa does restrict individual investments into foreign bond markets.[5]

7.2. Current law

7.2.1. *Government securities*

Examining inflows, FII investment in government bonds is capped at US$5 billion.[6] Previously applicable restrictions regarding the allocation of investment between equity and debt were revoked in October, 2008.[7] Foreign central banks are allowed to purchase these securities subject to the conditions stipulated by the RBI.[8] NRIs are allowed to purchase government bonds on an unlimited basis, with full rights of repatriation.[9] Foreign individuals and foreign corporates, in contrast, are not allowed by law to purchase these bonds.[10]

Looking at outflows, with the exception of the government, most actors, institutional or otherwise, face significant restrictions on purchases of foreign government securities. Domestic residents are constrained by the $200,000 limit on remittances under the "Liberalised Remittance Scheme", with regard to purchases of foreign government bonds.[11] Banks too, are not allowed to extend credit facilities or, effectively, to market to resident individuals.[12]

Corporations, pension, mutual and insurance funds are largely banned from investing in foreign government bonds. Corporates are prohibited from buying foreign government securities to the extent that the Foreign Exchange Management Act does not expressly authorise such purchases. With regard to pensions, the Pension Fund Regulatory Development Authority Act has not been passed by Parliament as of June 1, 2010. Preliminary draft regulations explicitly limit pension fund purchases

[4]Brickwork Ratings, An Update on the Recommendations for Developing the Indian Corporate Bond Market, September 2009 [hereinafter Indian Corporate Bond Market Recommendations Report].

[5]International Capital and Exchange Market Regulation (2009)(Braz.), *available at* http://www.bcb.gov.br/?RMCCINORMSNORM, ECONOMICS INTELLIGENCE UNIT, COUNTRY FINANCE SOUTH KOREA(2009), Exchange Control Manual (2009)(S.Afr.), *available at* http://www.reservebank.co.za/internet/publication.nsf/WCEV/8B1C8768741BF40C42256C44003331A6/?opendocument, DEUTSCHE BANK, DEUTSCHE BANK MARKET GUIDE TURKEY(2009). Note, as with our discussion of equity, the working group's assessment of South Africa's regulation of foreign investment is provisional.

[6]SEBI Circular No. IMD/FII &C /29/2007, dated 6-6-2008.

[7]SEBI (Foreign Institutional Investors) Regulations, 1995, [hereinafter SEBI FII Regulations] Regulation 15(1)(e); Foreign Exchange Management (Transfer or Issue of Security by a Person Resident outside India) Regulations, 2000, [hereinafter FEMA 20] Regulation 5(4), Schedule 5; SEBI Circular No. IMD/FII & C/ 33 /2007, October 16, 2008 [hereinafter SEBI Circular, October 16, 2008]. Pursuant to the SEBI Circular of October 16, 2008, prior requirements that FIIs not creating a 100 percent debt fund allocate investment between equity and debt instruments in the ratio of 70:30 have been repealed.

[8]FEMA 20, *supra*, note 7, Regulation 5(4), Schedule 5, Paragraph 2A. No conditions have been published to the extent of our knowledge.

[9]*Id.* At 2(1A(i)).

[10] *Id.* (granting express permission to purchase government bonds to FIIs, government or central banks and NRIs but not individuals and corporates).

[11]FEMA Master Circular No. 5/2009-10, (Master Circular on Miscellaneous Remittances from India-Facilities for Residents) Dated 1-7-2009, [hereinafter FEMA Liberalised Remittance Scheme] Issued by Foreign Exchange Department, RBI, at A13.

[12]*Id.* at 13.13.

of debt securities to those issued by the Government of India and certain corporations incorporated in India.[13] Insurance funds too, are limited to a specified schedule of investments that include Central and State government but not foreign government securities.[14] Insurance Regulatory and Development Authority regulations do include a category of "other" investment governed by a list of exposure or prudential norms.[15] Investment in foreign securities is not explicitly authorised. Ostensibly a fund could invest an appropriate percentage of their funds in foreign government securities pursuant to this schedule, though the intent and authority for this position appears speculative.

In contrast, mutual funds are allowed to buy government securities where a given country is rated not below investment grade.[16] Though mutual fund purchases are subject to quantitative restrictions.[17]

The Reserve Bank of India, of course, freely invests in foreign government securities. The Reserve Bank of India Act, 1934 ("RBI Act") does not have specific language authorising the purchase of foreign government bonds. Still the introduction to the Act broadly charges the RBI with "keeping reserves with a view to securing monetary stability,"[18] and particularly directs the RBI to perform central banking functions, including exchange and remittance operations and the management of public debt. [19]

7.2.2. *Corporate bonds*

Corporate bond regulation is complex. This complexity perhaps reflects policy positions and incentives that go beyond bond regulation understood in isolation.[20] Nonetheless, the working group presents the bare letter of the law of corporate debt regulation to at least start to facilitate a deeper understanding of the relationship between legal rules and economic policy.

Looking at inflows, companies other than financial intermediaries are eligible to borrow in foreign currencies within a variety of stipulated limits without prior approval.[21] In particular, company borrowing is capped at US $500 million under the automatic route[22] with detailed restrictions on end-use, maturity and more.[23] Non-compulsorily convertible preference shares are treated as debt, and the rules of

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[13] Pension Fund Regulatory and Development Authority (Registration of Intermediaries) Regulations, 200–, Preliminary Draft Regulations (September 2005), Regulation 46 & 55 (Stating that no investments may be made except in publicly traded debt securities issued by the Government of India, publicly traded debt securities of corporations incorporated in India that are regularly rated as investment grade by at least two rating agencies and loans of microfinance institutions established in India and guaranteed by the RBI).

[14] Insurance Regulatory and Development Authority (Investment) Regulations, 2000 [hereinafter IRDA Investment Regulations]. Regulation 4.

[15] *Id.*

[16] SEBI (Overseas Investment by Mutual Funds) IMD/CIR No. 7/104753/07, dated 26-9-2007, Paragraph 2(vii).

[17] *Id.* at 1. Within an overall limit of US $7 billion, mutual funds can make maximum investments of US $300 million per mutual fund overseas.

[18] Reserve Bank of India Act, 1934. Preamble.

[19] *Id.* at 20.

[20] For example, Companies Act requirements for corporate balance sheets are different from accepted Indian accounting standards, which in turn are different from international best practices. *See*, for example, Companies Act, 1956, Schedule 6.

[21] Foreign Exchange Management (Borrowing or Lending in Foreign Exchange) Regulations, 2000 [hereinafter FEMA Borrowing or Lending in Foreign Exchange Regulations] Regulation 6(1), Schedule I, Paragraph 1.(a) NBFCs, with the exception of infrastructure finance are not allowed external commercial borrowings. ECB policy will be discussed below.

[22] FEMA Borrowing or Lending in Foreign Exchange Regulations, *supra*, note 21 Regulation 6(1), Schedule I and II.(Borrowings can extend up to $750 million under the approval route)

[23] *Id.* Specified end uses include import of capital goods in infrastructure and industrial sectors, first stage acquisition of shares in the disinvestment process and direct investment in overseas joint ventures. Minimum average maturity is required to be not less than 3 years for borrowings up to US $20 million

ECB policy apply.[24] Compulsorily convertible preference shares are treated as capital under FDI scheme.[25]

FIIs are allowed to invest in corporate debt within specified limits. Specifically, FIIs may purchase non-convertible debentures or bonds of Indian companies up to limits issued by SEBI circulars.[26] According to the SEBI Circular dated March 13, 2009, US$8 billion would be auctioned to FIIs or sub-accounts on an open-bidding basis. Here, purchasers of rights to bid on non-convertible debentures are required to exercise such rights within 45 days. The rest US $7 billion is distributed amongst FIIs on a first come first serve basis.[27] FIIs are also allowed to invest in special debt instruments issued by banks up to an aggregate limit of 49 percent per issue, 10 percent for individual FIIs.[28] FIIs are also allowed to purchase convertible debentures within the same parameters and up to the same limits as for FII purchase of equity,[29] though the value for conversion and when this limit applies is not clear. Finally, individual investment by FIIs in security receipts issued by asset reconstruction companies is limited to 10 per cent of a given tranche of security receipts.[30] Total FII investment is capped at 49 percent of the paid up value of that tranche.[31]

NRIs are also allowed limited investment in Indian company debt.[32] In particular, NRIs may not participate in private placements, interest rates are capped and there are minimum maturity and end use restrictions. NRIs lending to Indian corporations are restricted to charging the State Bank of India prime lending rate plus 300 basis points.[33] Redemption periods may be no less than three years and the borrowing company cannot be involved in certain agricultural, plantation or real estate activities, trade in transferable development rights or serve as a nidhi or chit fund company.[34] NRIs cannot purchase bonds in the domestic corporate bond market under either the repatriation or non-repatriation route,[35] FEMA regulations allow limited purchase of convertible debentures on a repatriation basis and unlimited purchase of

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and not less than 5 years for borrowings greater than US $20 million up to the US $ 500 million limit. Authorised lenders are specified, though the definitions are broad. For example, section 1(iii)(a) and (c) lending by the international capital market, foreign collaborators or foreign equity holders is allowed: *See also,* Master Circular on External Commercial Borrowings and Trade Credits, RBI/009-10/27 Master Circular No. 07/2009-10, Part I(A)(v) for the automatic route, and Part I(B)(v) for the approvals route. All in cost ceilings lead to fluctuations and shocks just as the requirement to follow RBI pricing guidelines creates lack of clarity for future conversion of convertible debentures. FEMA 20, *supra*, note 7, at Regulation 5(1), Schedule 1, Paragraph 5(b)(requiring that the price of shares issued to persons resident outside India shall not be less than "the fair valuation of shares done by a SEBI registered Category-I Merchant Banker or a Chartered Accountant as per the discounted free cash flow method.")

[24]RBI/2009-10/27 Master Circular No. 07/2009-10, July 1, 2009, Part I.

[25]*See, supra* note 7, at Schedule 1

[26]FEMA 20, *supra* note 7, Regulation 5(4), and Schedule 5; SEBI Circular No. IMD/FII & C/38/2009, dated 13-3-2009. Every time there is an auction, SEBI issues a circular which specifies the limits within which an FII can seek an allocation of debt limits under the bidding process or the "first-in-first-out" or FIFO process.

[27]SEBI Circular No. CIR/IMD/FII/3/2010, (Allocation of Corporate debt investment limits to FIIs), dated June 11, 2010.

[28]SEBI Circular, October 16, 2008, *supra* note 7. Investment by FIIs in Tier II debt capital instruments are to be within limits stipulated by SEBI.

[29]FEMA 20, *supra* 7, Regulation 5(2), and Schedule 2, Paragraph 1, 4 (stating that the total holding by each FII shall not exceed 10 percent of the total paid up value of each series of convertible debentures, with aggregate holdings by all FIIs not to exceed 24 percent of such value.

[30]*Id.* at Regulation 5(4), and Schedule 5, Paragraph 1(iii).

[31]*Id.*

[32]Foreign Exchange Management (Borrowing and Lending in Rupees) Regulations, 2000[hereinafter FEMA Borrowing and Lending in Rupees Regulations].

[33]*Id.* at Regulation 5(1)(ii).

[34]*Id.* Resident individuals, not companies, may also borrow in rupees on a non-repatriable basis from NRIs subject to stipulated restrictions on loan period, interest rates and accounts through which these funds may be handled. See, *Id.* at Regulation 4.

[35]FEMA 20, *supra*, note 7, Regulation 5(4), and Schedule 5(1) and (2). FEMA Regulations expressly authorise Indian companies to sell non-convertible debentures or bonds to FIIs. The same regulations also authorise sales to NRIs of government dated securities, bonds issued by public sector undertakings and

the same if on a non-repatriable basis.[36] According to Schedule 3 of the Transfer or Issue of Security Regulations, NRIs may only hold 10 percent of the paid-up value of each series of convertible debentures-purchased on a repatriable or non-repatriable basis-though this ceiling can be raised to 24 percent upon passage of a special resolution by the board of directors and ratification by the general body of that company.[37] Schedule 4 of the same regulations, however, allow NRIs to purchase an unlimited amount of non-repatriable convertible debentures.[38] NRIs are also prohibited from investing in security receipts of asset reconstruction companies.[39] NRIs may lend to Indian individuals in rupees subject to specified conditions with regard to the repatriation, accounts in which such loans may be held, term and interest rates.[40] There are also no limits on investment on a repatriation basis in the bonds of public sector undertakings ("PSU"). [41]

Foreign companies can buy Indian corporate debt directly (as opposed to through registration and subsequent purchase as an FII) in two ways. First, Indian companies can issue debt abroad through the External Commercial Borrowings Route.[42] Second, Indian companies could issue convertible debt to foreign investors in India. This form of lending was characterised as capital.[43] A RBI Master Circular dated July 1, 2009 now characterises optionally convertible, partially convertible and non-convertible preference shares as debt.[44]

Thinking about corporate debt in convertible debentures, investors have the option of three different programs, Foreign Currency Convertible Bonds ("FCCB"), Foreign Currency Exchangeable Bonds ("FCEB") and External Commercial Borrowings.[45] FCCBs are similar to external commercial borrowings except that maturity is prohibited before 5 years, as opposed to 3 years for ECBs. FCEBs are issued for the debt of promoter group companies; the underlying security has to be a listed company and part of the same group of companies as the firm issuing the FCEB.[46] FCEBs come with end-use restrictions, specifically a prohibition on using the proceeds for investment in capital markets. RBI approval is needed. Minimum maturity for the instruments are 5 years. For both FCCBs and FCEBs, the application of RBI pricing guidelines

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shares in public sector enterprises being disinvested by the government, but not corporate bonds. The lack of express authorisation must then be read as a ban on sale of corporate bonds to NRIs. Additionally, NRIs would ostensibly be able to purchase the bonds of Indian companies abroad through the external commercial borrowings route, though members note that it was not clear whether NRIs are eligible lenders under the program. *See also*, FEMA Borrowing or Lending in Foreign Exchange Regulations, *supra*, note 21 (allowing lending through the capital market).

[36]FEMA 20, *supra*, note 7, Regulation 5(3)(i) and (ii) and Schedules III and IV.

[37]*Id.* at Schedule 3.

[38]Id. at Schedule 4.

[39]RBI/2005-06/203, A.P. (DIR Series) Circular No. 16, November 11, 2005. FIIs can invest up to 49 percent in security receipts of asset reconstruction companies with individual FIIs allowed up to 10 percent in each tranche of a given scheme of security receipts.

[40]FEMA Borrowing and Lending in Rupees Regulations, *supra*, note 32, at Regulation 4. (Requiring that loans be directed through Non-resident External ("NRE"), Non-resident ordinary ("NRO"), Foreign Currency Non-resident, Non-resident non-repatriable or non-resident special rupee ("NRSR") accounts. Loans may not exceed three years, interest rates may not exceed two percentage points over Bank rates at the day of the loan, and the amount borrowed may not be repatriated outside the country.

[41]FEMA 20, *supra*, note 7 Schedule 5. Also, shares of PSUs which are being divested are treated as debt for the purposes of repatriability by NRIs.

[42]FEMA Borrowing or Lending in Foreign Exchange Regulations, *supra*, note 21, at Regulation 5, Schedule I and II. (Schedule I permits borrowing on international capital markets and directly through collaborators or international agencies up to limits of US $500 million. Schedule II allows the same borrowing over the limit with RBI approval.)

[43]FEMA 20, *supra* note 7, Regulation 5(1), Schedule I.

[44]RBI/2009-10/27 Master Circular No. 07/2009-10, July 1, 2009.

[45]FEMA Borrowing or Lending in Foreign Exchange Regulations, *supra*, note 21 authorises ECBs; FEMA Transfer or Issue of Any Foreign Security, Regulation 21(2)(i) and Schedule 1 authorises FCCBs; Issue of Foreign Currency Exchangeable Bonds (FCEB) Scheme, 2008 authorises FCEBs.

[46]Issue of Foreign Currency Exchangeable Bonds, *See, supra*, note 45 at Paragraph 3.

prevent creation of contracts with predetermined ratio for conversion of shares in the future.[47]

Foreign individual purchase of Indian corporate debt receives the same treatment, prohibitions and exceptions, for the same reasons, as foreign corporates. FEMA regulations expressly authorise and limit the power to purchase securities to certain specified categories of institutions; FIIs, NRIs, foreign central banks and venture capital undertakings registered with the Securities and Exchange Board of India,[48] not foreign individuals. As such, Indian companies may not approach individuals to buy rupee or foreign currency denominated non-convertible debentures, convertible debentures or security receipts. Foreign individual purchase of unlisted debt in India must proceed through the ECB route.[49] Note that resident individuals are not easily able to borrow abroad. Residents may borrow up to the equivalent of US $250,000 though such loans must be on highly concessionary terms from family.[50]

Looking at outflows into corporate debt or, to state matters differently, individual and institutional Indian purchase of overseas corporate bonds, offers a mixed picture. As will be discussed below, individuals and mutual funds are permitted remittances and limited purchase of foreign debt securities respectively. Corporations may forward loans only as direct investment outside India to their joint ventures or wholly owned subsidiaries. Outflows by other institutions like pension funds, insurance funds and banks are prohibited. The working group felt that most of these restrictions were driven by concerns for consumer protection. Were these concerns to be addressed, the working group felt that diversification of Indian portfolios through outbound flows into corporate debt can reduce risk for Indian residents.

Individuals are allowed a defined amount of remittances and purchase of foreign debt securities. Specifically, the Liberalised Remittance Scheme allows residents of India to remit up to US $200,000 for current or capital account transactions without prior permission of the RBI.[51] Residents are specifically authorised to invest in debt securities,[52] though banks are prohibited from extending credit facilities to facilitate these transactions.[53] Though individuals are permitted to purchase foreign corporate debt, they have no distribution channels, through which this can be achieved.

Mutual funds are allowed defined investments in foreign debt. In particular, mutuals are allowed to purchase debt in "countries with fully convertible currencies," and in short or long term debt with ratings "not below investment grade" by accredited credit ratings agencies[54] up to an aggregate ceiling of US $7 billion.[55] Such funds

[47]FEMA 20, *supra*, note 7, Regulation 5(1), and Schedule 1, Paragraph 5.

[48]*Id.*

[49]FEMA Borrowing or Lending in Foreign Exchange Regulations, *supra*, note 21, at Regulation 6(1), Schedule 1, Paragraph 1(iii)(c) and (e) as well as Regulation 6(2), Schedule 2, Paragraph 3(ii)(c) and (e).(Allowing "foreign collaborators" or "any other eligible entity" as specified by the RBI to lend through the ECB program under the automatic and approvals route respectively).

[50]FEMA Borrowing or Lending in Foreign Exchange Regulations, *supra*, note 21, at Regulations 5(6), 6 and Schedule 1 and accompanying text. (Stating that individual residents in India may borrow up to US $250,000 so long as the minimum maturity period of the loan is one year, the loan is free of interest and the amount of loan is received in inward remittance in free foreign exchange. Indian residents may also borrow in accordance with the provisions of the automatic route specified in Schedule 1 with all its attendant end-use restrictions).

[51]FEMA Liberalised Remittance Scheme, *supra*, note 11, at A13.

[52]*Id.* at A.13, 13.5. The broad permission to invest in debt securities would ostensibly cover investments in non-convertible debentures, convertible debentures and collateralized debt obligations.

[53]*Id.* at A 13, 13.13.

[54]FEMA Transfer or Issue of Any Foreign Security Regulations, 2004 [hereinafter FEMA Transfer of Foreign Security Regulations], at Regulation 6C; SEBI Circular No. IMD/CIR No.7/104753/07 (Overseas Investments by Mutual Funds) dated 26-9-2007 at Paragraph 2(ii)-(iv). Permission to invest in non-convertible debentures is found in Paragraph 2(iv)s authorisation of investment in debt securities broadly, while permission to invest in convertible debentures would lie in Paragraph 2(ii) and 2(iii)s authorisation of investment in equity read with Paragraph 2(iv).

[55]SEBI Circular No. IMD/CIR No.2/122577/08 (Overseas Investments by Mutual Funds) dated 8-4-2008 at Paragraph 2.

do not have explicit authorisation to invest in foreign security receipts.

Indian corporates are allowed limited investment in foreign corporate debt.[56] Specifically, Indian companies are allowed to invest in the rated bonds or fixed income securities of overseas companies listed on a recognised stock exchange so long as the investment does not exceed 50 percent of the company's net worth as of the date of its last audited balance sheet.[57] There is no express textual authorisation of Indian company purchase of foreign security receipts. There is also no textual authorisation of domestic pension fund, insurance fund or bank purchase of foreign debt securities.

7.3. Exchange rate risk

The working group looked closely at disproportionate borrowings on foreign capital markets. In particular, the group was concerned about currency mismatches created by foreign-currency borrowing putting institutions and the economy at risk of exchange rate fluctuations.[58] Stated differently, currency mismatches create inherent, structural or systemic risk for the Indian economy upon changes in the exchange rate. Currency mismatches also create political economy pressures to manage the exchange rate whereas foreign participation in rupee-denominated debt can help energise these markets. The working group felt that incentivizing rupee-denominated debt is a safer way of managing globalisation. Furthermore, bond financing could be an important way to finance infrastructure needs.[59] In India, restrictions on rupee denominated debt–the process of issuing non-convertible debentures is seen by many to be quite onerous in comparison to the process for external commercial borrowings–combined with leverage allowed under the overseas direct investment route creates incentives for greater foreign currency borrowings, currency mismatches and vulnerability.[60]

7.4. Quantitative restrictions

7.4.1. *Analysis*

Despite its successes, certain formal restrictions on participation in the government and corporate bond markets remain. Notably, both debt markets are marked by quan-

[56] *See*, FEMA 20, *supra*, note 7, at Regulation 5 (authorising various forms of direct and portfolio investment); FEMA Transfer or Issue of Any Foreign Security, *supra* note 54, at Regulations 5, 6 and 6B.

[57] FEMA Transfer or Issue of Any Foreign Security Regulations, *supra* note 54, at Regulations 5, 6 and 6B(b)(i). Pursuant to Regulations 5 and 6, corporations are also allowed to make "direct investment" into a "Joint Venture or Wholly Owned Subsidiary" outside India so long as the total financial commitment in the "JV/WOS" does not exceed 400 percent of the net worth of the company as of the date of the last audited balance sheet.

[58] Barry Eichengreen, Ricardo Hausmann and Ugo Panizza, *The Pain of Original Sin, in* OTHER PEOPLE'S MONEY: DEBT DENOMINATION AND FINANCIAL INSTABILITY IN EMERGING-MARKET ECONOMIES, (B. Eichengreen and R. Hausmann eds., 2005).

[59] There was some debate within the working group as to the extent to which countries have actually used bond financing to finance infrastructure. The Asian Development Bank ("ADB") in a Regional Technical Assistance Report on bond financing for infrastructure projects in the ASEAN+3 region suggests that various types of bonds-government bonds, corporate bonds, revenue bonds and project bonds-can be issued to finance infrastructure projects, and that infrastructure bonds can be a more efficient form of financing to the extent that it meets the long term nature of infrastructure financing which is often not available in the banking system. The ADB also found that bond financing brings greater transparency to transactions and the financial market as a whole. ASIAN DEVELOPMENT BANK, BOND FINANCING FOR INFRASTRUCTURE PROJECTS IN THE ASEAN+3 REGION 2 (2008).

[60] India's financial sector regulation has historically reflected a distinct wariness of debt.*See*, Y. V. Reddy, Introduction, *in* INDIA AND THE GLOBAL FINANCIAL CRISIS 33 (Y.V. Reddy ed. 2009). The policy preferences of the RBI and the Government of India, as reflected in regulation to date, suggests preferential treatment of equity over debt and perhaps reflects concerns with the relationship between external debt and the cost of debt servicing and the differential between interest rates and inflation leading to high, short term flows and volatility in the country's markets.

titative restrictions on the purchase of bonds by FIIs.[61] As noted above, foreign investor, particularly FII investments in government and corporate securities are capped cumulatively at US $5 and $15 billion respectively. While the working group notes that this headroom is unused, we note that this lack of use is itself a sign of larger problems in debt markets. Of course, a foreign investor can engage with RBI seeking to alleviate the constraints posed by the quantitative caps. Yet, this cumbersome process – and the possibility that the cap would not be raised, thus bring the investment process to a standstill – hampers international acceptance of rupee-denominated debt. These restrictions then incentivise or contribute to the problems with exchange rate risk discussed in the previous section.

Furthermore, the working group feels that aggregate caps remove the incentive for foreign financial firms to build practices in and engage deeply with India. Global financial firms are concerned about undertaking salary and other fixed costs of building India-focused teams, when this investment has a stop-go character, with periodic cessation of activity when limits are reached. Foreign financial firms may hence reasonably choose not to invest in organisation building focusing on Indian debt securities in the first instance. This limitation on financial development in turn would lead to the lack of development of India's corporate debt market with subsequent limitations placed on India's financing needs. Note that the Tarapore Committee has recommended that ceilings for investment in government and corporate debt should be calibrated through percentages.[62] The Tarapore Committee has also recommended that the overall ceiling for external commercial borrowings as well as the ceiling under the automatic route should be gradually raised and end-use restrictions removed.[63]

7.4.2. *Recommendations*

The working group recommends that numeric caps on rupee-denominated corporate debt be removed or at least replaced with percentage caps as suggested by the Committee on Fuller Capital Account Convertibility. Raising or removing the cap on such investment is of course the obvious precondition for addressing issues of currency mismatch, exchange rate risk and original sin.

The working group emphasises that the point of analysis should not be questions of debt versus equity but rupee-denominated debt versus foreign currency denominated debt. Foreign investors sharing the risk of investment in India is a positive feature for the economy as a whole. Furthermore, the systemic risks associated with extensive foreign currency debt should not be minimised, let alone incentivised.

Current debt quotas in rupee-denominated debt markets are underutilised, yet the fact of quantitative limits and the lack of institutional development of the bond markets are in themselves significant reasons for the lack of corporate debt issuance. As suggested earlier, removing quantitative restrictions would also provide an impetus to the development of financial services within India and further the sophistication and capabilities of the Indian economy.

A percentage limit (similar to the ones applied to the equity market) would be superior for two reasons. Firstly, it would create incentives for international financial firms to develop debt practices for India and secondly, there would be no need for

[61] NRIs, however, face no limit on purchases of government bonds and may invest in these securities on repatriable or non-repatriable basis.

[62] Report of the Committee on Fuller Capital Account Convertibility 50, 53 (2006)[Hereinafter Tarapore Committee Report](Discussing FII investment in government securities which the working group feels should be developed as a percentage of gross issuance and FII investment in corporate bonds which should be linked to fresh issuances).

[63] Report of the Committee on Fuller Capital Account Convertibility 142 (2006). Limits on outflows have been raised from 200 percent of net worth to 400 percent of net worth for corporations, though not for partnerships and sole proprietorships as recommended by this committee.

regular regulatory action to increase the caps, as with increase in size of the market, the absolute value allowed to foreigners would continue to increase.

7.5. Foreign currency borrowing: ECB policy

External commercial borrowings involve two systems, for investment by automatic and approvals routes, which involve significant complexity. Within these two systems there are a number of restrictions that have been placed which include, the businesses which can borrow, the entities which can be lenders, the maximum amount that can be borrowed, the maximum interest that can be paid, the minimum period of maturity of such loans, the purposes for which such loans can be used, guarantees or securities that may be given, the way that funds may be invested before actual utilisation, conditions before such loans can be pre-paid, and a total limit on the amount of borrowings in foreign currency that is allowed every year. In turn, some conditions are dependent on other conditions; the minimum period of maturity of loans, for example, depends on the amount borrowed.

The working group notes that there are a number of questions involving ECB policy that bear reviewing. For example, why are only limited service sectors allowed to access the ECB route? Why do foreign equity holders need to have at least 25 percent equity stakes to become eligible lenders under the automatic and approval routes? Why is the services sector not mentioned in the approvals route? What is the rationale for restricting the access to ECBs of banks, housing finance companies, NBFCs and other financial institutions? Is there any annual limit that can be raised through ECBs?

For strategic reasons, this working group focused our energies on issues of exchange risk and foreign currency mismatch, what we perceive to be the greater source of risk to the Indian economy. No doubt, ECB policy should be reviewed and formulated with clear principles of economic reasoning in mind. The sheer number of classifications should be minimised and policies between categories harmonised. Yet, the group feels that India's engagement with the global economy would proceed better with a heavy policy focus on rupee-denominated debt.

7.6. Institutional development

7.6.1. *Analysis*

As noted above, India's corporate debt markets are moribund with concomitant negative implications for meeting India's financing needs. The functioning (or lack thereof) of a variety of factors and institutional mechanisms explain this state of affairs which have been well-documented in government committee reports over the last few years.[64]

Thinking of institutional factors, the state of development of India's bond markets can perhaps be analogised to the state of India's equity markets before the takeoff.

[64] *See*, Government of India, Ministry of Finance, Report of the High Level Expert Committee on Corporate Bonds and Securitisation, 2005. (Also known as the Dr. R.H. Patil Committee Report); Government of India, Ministry of Finance, The Report of the Committee on Infrastructure Financing, 2007. (Also known as the Investment Commission); Government of India, Ministry of Finance, The Report of the High Powered Expert Committee (HPEC) on Making Mumbai an International Financial Centre, 2007. (Also known as the Percy Mistry Committee); Government of India, Ministry of Finance, A Hundred Small Steps: Report of the Committee on Financial Sector Reform, 2008. (Also known as the Raghuram Rajan Committee); Government of India, Ministry of Finance and Reserve Bank of India, The Report of the Committee on Financial Sector Assessment, 2009; Brickwork Ratings, An Update on the Recommendations for Developing the Indian Corporate Bond Market, 2009 [hereinafter, Brickwork Ratings Report].

The working group notes that a variety of measures would have to be taken to create the incentives and investor confidence for a deep and liquid corporate bond market. SEBI and the RBI have taken a lot of steps to deepen the corporate bond market. These measures include notifying guidelines for allowing repo or repurchase agreements in corporate bonds,[65] allowing NBFCs to serve as Qualified Institutional Buyers ("QIBs") for investments in security receipts,[66] and streamlining the procedures for listing and issuing debt securities and securitised debt.[67] The RBI is also proposing to introduce interest rate futures on 5 year and 2 year notional coupon bearing securities and 91 day Treasury Bills, finalise guidelines on the issuance of non-convertible debentures of less than one year maturity, and facilitate settlement of secondary market trades in corporate bonds on a delivery versus payment-1 ("DVP-1") basis on the Real Time Gross Settlement ("RTGS") system among other measures.[68]. Yet, issues identified by government committees alone in the last five years which remain to be implemented include:

1. Lack of a market-maker scheme for corporate bonds including incentives for intermediaries to evolve an efficient market maker support mechanism for these market makers and permission to undertake repos;
2. Permitting insurance, pension, provident and gratuity funds to invest in corporate debt;
3. Rationalisation of stamp duty on securitised products;
4. Allowing tax pass through for securitised Special Purpose Vehicles ("SPVs") and Non-Performing Assets Securitisation to place them on par with SEBI recognised VC funds;
5. Addressing issues under the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interests Act, 2002 ("SARFAESI")[69];
6. Creating certain credit enhancement mechanisms[70]
7. Creating a specialised debt fund for funding infrastructure projects.[71]

The working group also noted that processes are as important as rules. For example, the working group found that disclosure documents for debt investments can be onerous and that the relative ease of foreign borrowing leads many corporates to raise foreign currency debt through external commercial borrowings rather than rupee-denominated debt through issuance of non-convertible debentures. Here, the

[65] Repo in Corporate Debt Securities (Reserve Bank) Directions, 2010, RBI/2009-10/284 IDMD.DOD. 05/11/08.38/2009-10, dated 8-1-2010.

[66] SEBI Notification No. F. No.11/LC/GN/2008/21670, dated 31-3-2008.

[67] Securities and Exchange Board of India (Issue and Listing of Debt Securities) Regulations, 2008.

[68] D. Subbarao, RBI Governor, Annual Policy Statement for the Year 2010-11, (April 20, 2010) at items 58, 59 and 65(i)

[69] SARFAESI Act issues include amending the definition of security receipt in Section 2(zg) of the Act to allow security receipt holders to use them as evidence to claim rights on cash flows from realisation of the security asset; allowing Qualified Institutional Buyers to invest in security receipts.

[70] Credit enhancement mechanisms include allowing bonds issued by state governments or SPVs for the purpose of infrastructure financing to bring in credit enhancements with pooling of assets and selling tranches of these assets with various ratings to allow investors to acquire assets based on their risk preferences; reviewing the capital adequacy guideline from the RBI to reduce the double counting of capital requirements for credit enhanced debt instruments; reviewing capital requirements where the issuers of securitised standard assets are banks and FIs and the same institution is also the credit enhancer.

[71] This could include allowing rupee debt funds to register within the SEBI VC, now possibly the QFI framework; passing regulation to limit investments in listed debt funds to a third of the fund size similar to current SEBI VC funds; giving these funds the option of getting listed after a year from financial closure, giving investors the option of opting out, given the presence of sufficient liquidity; treating these funds on par with VC funds; allowing bank participation in such funds where capital market exposure limits would not be applied in these cases; encouraging the regulators of provident, insurance and pension funds to allow participation in these infrastructure debt funds; and, allowing foreign debt to participate in these funds at an appropriate stage.

working group suggests consideration of a variety of proposals such as, for purposes of meeting disclosure requirements, counting documentation provided for equity investments or the simple filing of a periodic prospectus-like document.

Finally, the working group notes that some currency risk and legal uncertainty is unavoidable. Investment structures can always be designed to approximate ends that policy makers hope to avoid; for example, local currency denominated bonds indexed or payable in foreign currency. Furthermore, the possibility of foreign courts taking jurisdiction by finding a reasonable connection between a transaction and a forum, particularly where choice of law is not contractually specified, creates legal uncertainty and can have some affect on the investment climate for foreign investors. Not least, incentives for Indian firms to borrow abroad continues for straightforward reasons; deep and liquid foreign markets can often offer lower costs of borrowing etc.

7.6.2. *Recommendations*

Thinking of the institutional factors required to develop India's bond markets can perhaps be analogised to the 10 years needed to put regulators and systems in place between the reforms of the early '90s and the equity-market takeoff in 2003. As suggested above, the working group strongly feels that developing the rules and systems for a deep and liquid bond market for domestic investors will attract foreign investment as well. Fourteen of twenty-two recommendations on corporate bonds, of five committee reports from 2005 to 2009 have either been partially implemented, or not implemented at all.[72] Simply following through with the involved spade work suggested by recent government committees will lay the ground for a more robust corporate debt market. This is no doubt a complex and arduous set of processes that would take significant government attention and staff time to see to completion. Yet the long term benefits to the economy can be significant.

7.7. QFI and debt

The QFI model discussed earlier can and should be implemented for investment in government or corporate debt. As stated before, entity level classifications would be removed. All investors would be treated neutrally after clearance of capital flows management regulations. The regulator of the capital markets, SEBI, would continue to focus on market integrity issues. Simplification of the process of administering and clearing capital flows management regulations will not affect the Reserve Banks ability to administer overall restrictions or limits on capital flows, as deemed appropriate. The Reserve Bank would still define the percentage cap on foreign investment in Indian debt.

7.8. Outflows into debt

As discussed in the chapter on equity, the working group felt that policy consideration of outflows is important for reasons of diversification. Investing abroad offers Indian investors, all residents of India, greater security through diversification of holdings, though such investment is predicated upon appropriately strong consumer protection rules. With outflows under the Liberalised Remittance Scheme, the working group recommends that all entities structuring and offering securities market-related products in the overseas market, who offer these markets to residents in India, should

[72] *See*, Dr. R.H. Patil Committee Report, the Investment Commission, the Percy Mistry Committee, the Raghuram Rajan Committee, The Report of the Committee on Financial Sector Assessment, Brickwork Ratings Report, *supra* note 64.

register with SEBI and fully disclose all promotional materials. As stated earlier, SEBI would simply provide comments and neither approve nor disapprove given products, though SEBI could still reserve the right to ask that a given product be removed from the market. These proposed guidelines would not be applicable to Indian residents investing in domestic funds which in turn invest abroad. These guidelines would not apply to those who do not carry out any activities within the territory of India. Plain vanilla investment products like bank deposits that do not involve exposure to securities would not be governed by these proposed guidelines. Applicants would be duly regulated and authorised to offer such products by the securities market regulator in its home jurisdiction as specified by SEBI.

7.9. Required legal changes

The legal changes involved in implementing the major recommendations of this working group are both straightforward and, cumulatively, many. Fairly simple changes in regulation can remove quantitative restrictions on foreign investment in debt though implementing the package of recommendations compiled by expert committees in recent years will require a number of different actions.

In thinking of procedural concerns and institutional development of the corporate bond market and implementing the recommendations of recent committee reports, most changes can be handled at the agency or Ministry level. For example, a SEBI notification of May, 2009 simplified listing procedures and reduced disclosure requirements for listed entities. Parliamentary changes would be needed for modification of certain statutes. The Securities Contract (Regulation Act) of 1956, ("SCRA") for example, would have to be amended to include pass through certificates and other securities issued by special purpose vehicles and trusts as "securities" under SCRA.[73]

SARFAESI would have to be amended to allow QIBs to invest in security receipts, to develop the wholesale market for securitised assets and more. Agency action by PFRDA and IRDA would also be needed for certain actions, such as allowing insurance and pension funds to be part of the investor base for collateralized loan obligations and collateralized debt obligations.

Quantitative restrictions can be removed by rescinding the limit on FII debt or replacing hard caps with percentage limits.[74] Multiple channels for foreign currency debt could also be consolidated.[75] QFIs would be authorised to invest in security receipts on par with domestic investors[76] and different treatment of PSU debt and other company debt, FCEB and FCCB could be consolidated into a combined limit.

[73]Working group members argued that Section 2(h)(ie) of SCRA may potentially already include instruments issued by an SPV within the definition of "securities" and accordingly may not require amendment.

[74]For rupee debt involving both convertible debentures and non-convertible debentures, the newly created QFIs would be treated on par with domestic investors. This would involve changes to SEBI (FII) Regulations, FEMA (Transfer or Issue of Security) Regulations, FEMA (Borrowing and Lending in Rupees) Regulations and SEBI Circular IMD/FII & C/33/2007, October 16, 2008.

[75]This would involve changes to FEMA (Transfer or Issue of Any Foreign Security) Regulations, *supra* note 54, as well as FEMA (Borrowing or Lending in Foreign Exchange Regulations), *supra* note 21.

[76]FEMA 20, *supra* note 7, Schedule 5.

7.10. Annexure

7.10.1. *State of implementation of committee recommendations for corporate bond market*

Recommendations	Committees	Actions taken
Reform of the stamp duty	a) Patil Committee b) Tarapore report II	Differential stamp duty across states
Listing requirements for corporate bonds to be made simpler	Patil Committee	Simplified listing agreements for debt securities
Incremental disclosures for already listed securities	Patil Committee	Simplified listing agreements for debt
Institutional reporting, trading and settlement system for corporate bonds	a) Patil Committee b) Tarapore report II	SEBI circulars dated Dec 12, 2006, March 11 2007 and April 2007
End use restrictions on ECBs should be removed	Tarapore Report I	End use restrictions still exist.
Policy governing ECBs should be applicable to FCCBs	Tarapore Report I	Implemented: The policy governing ECBs, FCCBs and FCEBs are broadly uniform. Though FCCBs and FCEBs are also partially governed by the guidelines on ADRs/GDRs.
Raise limits on outbound investments by corporates in Jvs/WOS from 200% to 400% of net-worth.		Implemented: FEMA (Transfer or issue of any foreign security) Regulations, 2004.
Allocation by SEBI of the limits between 100% debt funds and other FIIs to be discontinued.	Tarapore II	Implemented: There is no distinction between 70:30 and 100% debt funds.
Corporate bonds to be permitted as eligible securities for repo transactions	Tarapore II	Implemented: Repo in Corporate Debt Securities (Reserve Bank) Directions, 2010.
Open up investment in rupee corporate and government bond markets to foreign investors.	Rajan Report	FII limit raised to USD 15bn in corporate bonds and capped at USD 5bn for government securities.
Greater outward investment by provident funds and insurance companies.	Rajan Report	Not implemented.
Bring all regulations of trading under SEBI	Rajan Report	As far as corporate bonds are concerned, the government issued a clarification on the regulatory jurisdiction of corporate bonds. SEBI will be responsible for the primary and secondary market in corporate bonds and RBI will be responsible for repo and reverse repo transactions in corporate bonds.
Encourage FDI in Asset Reconstruction Companies ("ARCs").	Rajan Report	FDI is allowed in ARCs.
Need for a well-functioning bankruptcy code.	Rajan Report	
Securitised debt listing	Patil Committee	SEBI (Public Offer and listing of Securitised Debt Instruments) Regulations, 2008.
Stamp duty on securitised debt	Patil Committee	
Listing of issues	Patil Committee	SEBI (Issue and listing of Debt Securities) Regulations, 2008.

7.10.2. *Capital flows management regulations: Government debt*

Inflows	FII	INDIVIDUAL	CORPORATES	NRI	GOVERNMENT
Govt. dated securities	2	1	1	5	3

Outflows	INDIVIDUAL	CORPORATES	GOVERNMENT	MUTUAL FUNDS	PENSION FUNDS	INSURANCE FUNDS
Govt. dated securities	2	1	5	2	1	1

KEY	Complete Ban				Fully Open
	1	2	3	4	5

7.10.3. *Capital flows management regulations: Corporate bonds*

Inflows	FII	NRI	CORPORATES	INDIVIDUAL
NCD – Rupee denominated	2	3	1	1
NCD – Foreign currency denominated	2	2	3	1
Convertible Debentures	4	4	1 | FDI	1
Collateralised Debt Obligations / SRs	4	1	1	1

Outflows	INDIVIDUAL	MUTUAL FUNDS	CORPORATES	PENSION FUNDS	INSURANCE FUNDS	BANKS
Non–Convertible Debentures	3	3	1 | ODI	1	1	1
Convertible Debentures	3	4	1 | ODI	1	1	1
Collateralised Debt Obligations	3	1	1	1	1	1

KEY	1 (Complete Ban)	2	3	4	5 (Fully Open)

7.10.4. *BSST countries*

Government Bonds

		India		Brazil		South Korea		South Africa		Turkey	
		Inflows	Outflows	Inflows	Outflows	Inflows	Outflows	Inflows	Outflows	Inflows	Outflows
Investor type differentiation		1	1	0	0	0	1	0	0	0	0
Quantitative restrictions	Level	1	1	0	0	0	0	0	0	0	0
	Percentage	0	0	0	0	0	0	1	1	0	0
Taxation measures		1	1	1	0	0	0	0	0	1	0

Note: 1 = Yes, 0 = No.

Corporate Debt

		India		Brazil		South Korea		South Africa		Turkey	
		Inflows	Outflows	Inflows	Outflows	Inflows	Outflows	Inflows	Outflows	Inflows	Outflows
Investor type differentiation		1	1	0	0	0	0	0	0	0	0
Quantitative restrictions	Level	1	1	0	0	0	0	0	0	0	0
	Percentage	0	0	0	0	0	0	0	1	0	0
Taxation measures		0	0	1	0	0	0	0	0	0	0

Note: 1 = Yes, 0 = No.

CHAPTER 8

Derivatives

The working group's derivatives discussions examined the overlaps between prudential regulation and foreign investment in derivatives; in particular, we emphasized the development of integrated, level playing fields. An initial section will present the current law of derivatives trading, by inflows and outflows, and with regard to institutional and individual actors such as FIIs, domestic corporates, banks, mutuals, pension and insurance funds, NRIs, foreign individuals and domestic residents. A second section will take up country comparisons. Subsequent sections will examine the role of derivatives trading as a balance of payment matter, the differential regulation of forwards, futures and spot markets, the differing treatment of foreign and domestic investors with regard to position limits, offshore derivatives trades and outflows or issues with regard to Indian residents trading in derivatives abroad.

8.1. Current Law

8.1.1. *Inflows*

Examining inflows–which are understood by this working group to represent foreign investment into derivatives trade in India, regardless of the location of the underlying security–FIIs are allowed certain investment in currency and equity-based derivatives and limited investment in interest rate derivatives though FII investment in commodity and fixed income derivatives is banned. Thinking of currency derivatives, FIIs may enter into a forward contract with an Indian individual or entity, with rupees as one of the currencies involved, to hedge currency exposure in India.[1] The value of the hedge is not allowed to exceed the market value of the underlying instrument and such contracts, once booked, shall continue to their original maturity even if the value of the underlying asset shrinks for reasons other than the sale of securities.[2] However, FIIs are banned from trading exchange traded currency futures and options.[3] Looking

[1] *See*, Foreign Exchange Management (Foreign Exchange Derivative Contracts) Regulations, 2000 [hereinafter FEMA Foreign Exchange Derivative Contracts] Regulation.5, and Schedule II.

[2] *Id.* at Schedule II, Paragraph 1(a)

[3] Currency Futures (Reserve Bank) Directions, 2008, *read with*, Foreign Exchange Management(Foreign Exchange Derivative Contracts) Regulations, 2000, at Regulation 5, *read with* Schedule II, Paragraph 1; SEBI (Foreign Institutional Investors) Regulations, 1995, [hereinafter SEBI FII Regulations] at Regulation 15.

at equity-based,[4] and interest rate derivatives,[5] FIIs are authorized to invest exclusively in exchange-traded derivatives subject to specified position limits. FIIs have no authorization to trade in commodity or fixed income derivatives.

NRIs are also allowed limited trading in derivatives in the same categories and to largely the same extent as FIIs. With currency based derivatives, NRIs are allowed to enter into forward contracts with rupees as one of the currency to hedge dividends due on shares held in Indian companies, the balances held in specified non-resident accounts or investments made under the portfolio scheme notified in FEMA regulations.[6] With equity-based derivatives, NRIs are given the same client level position limits specified by SEBI.[7] An NRI, or group of NRIs acting together, who own 15 percent or more of the open interest of all derivative contracts on a particular underlying index must disclose their position.[8] For NRIs holding stock option and single stock futures contracts, the gross open position across all derivative contracts of a particular underlying stock is not allowed to exceed the greater of 1 percent of the free float market capitalization or 5 percent of the open interest in derivative contracts on a particular underlying stock.[9] With exchange traded interest rate derivative contracts, NRIs face position limits of Rs.100 crores or 15 percent of total open interest in the market for such contracts.[10] While persons resident outside India, including ostensibly NRIs, are allowed to hedge FDI and proposed FDI investments,[11] they do not appear to have any authorization to trade in commodity or fixed income derivatives.

8.1.2. *Outflows*

Looking at outflows–understood by this working group to include investment by Indian residents into derivatives trading abroad, regardless of the location of the underlying security–outbound flows into derivatives for residents are available on a limited basis.[12] Individuals may only enter into forwards to hedge risks.[13] Contracts must be entered into with authorized dealers.[14] FEMA Regulations also specify limits with regard to maturity, accounting and approvals with regard to different underlyings.[15]

[4]SEBI FII Regulations, *supra*, note 3 Regulation 15(1)(d) (stating that FIIs may invest in only a specified list of investments, including derivatives traded on a recognized stock exchange); Foreign Exchange Management (Transfer or Issue of Security by a Person Resident outside of India) Regulations, 2000, Regulation 5(6) and Schedule 5, Paragraph 1 (authorizing FII trading in exchange traded derivative contracts with securities as collateral); SEBI Circular No. DNPD/Cir-30/2006, dated 20-1-2006 (detailing position limits for stock based derivatives). Stocks having applicable market-wise position limit ("MWPL") of Rs.500 crores or more are allowed a combined futures and options position limit of 20 percent of MWPL or Rs.300 crores, whichever is lower. Within this limit, stock futures position limits are not allowed to exceed 10 percent of applicable MWPL or Rs.150 crores, whichever is lower. Stocks having applicable MWPL less than Rs.500 crores are permitted combined futures and options position limits of 20 percent of applicable MWPL. Futures positions here may not exceed 20 percent of applicable MWPL or Rs.50 crores, whichever is lower.

[5]SEBI Circular No. DNP/CIR-21/2004/03/09, dated 9-3-2004 [hereinafter SEBI Circular, March 9, 2004] (detailing position limits for interest rate derivatives). FIIs are permitted to trade in such derivatives with gross open position of notional value of $100 million. FIIs are also allowed exposure in such contracts to the extent of the book value of their cash market exposure to government securities. FII sub-accounts are allowed position limits of the higher of Rs.100 crores or 15 percent of total open interest in the market in exchange traded interest rate derivative contracts.

[6]*See*, FEMA Foreign Exchange Derivative Contracts, supra note 1, Regulation 5, and Schedule II

[7]SEBI Circular No. DNPD/Cir-17/23/10/29, dated 29-10-2003.

[8]*Id.*

[9]*Id.*

[10]SEBI Circular, March 9, 2004, *supra* note 5.

[11]FEMA Foreign Exchange Derivative Contracts, *supra*, note 1, at Regulation 5 and Schedule II, Paragraph 3 and 3(A).

[12]*Id.*

[13]*Id.* at Schedule I, Paragraph A.1.

[14]*Id.*

[15]*Id.* at Schedule I, Paragraph A.1. For example, foreign currency loans or bonds are eligible for hedging only after final approval is provided by the RBI. See, *Id.* at (e); To use another example, global depository

Interest rate, currency or coupon swaps, as well as foreign currency options, interest rate caps, collar (purchases) or forward rate agreement contracts are permitted for covering loans, though there are many other restrictions.[16] Commodity hedges are allowed though legal persons are subject to disclosure requirements and RBI discretionary approval.[17] Remittances for margins or margin calls are not allowed to individuals, however, under the liberalized remittance scheme out of concern that allowing payments up to the LRS amount will lead to notional liabilities far exceeding the cap.[18]

Mutuals are also allowed defined outbound investments into derivatives. SEBI permits outbound investments in derivatives by mutuals, for purposes of "hedging and portfolio balancing," only on recognized stock exchanges, "with underlying as securities.[19] Mutuals are also allowed to invest in overseas exchange trade funds that invest in securities up to a total industry cap of US $1 billion and $50 million per mutual fund, and upon complying with various procedural requirements.[20]

Corporations appear to enjoy limited authorization to enter into outbound derivatives contracts. Specifically, FEMA regulations authorize persons resident in India, which include companies registered in India, to enter into foreign exchange derivative contracts to hedge exposure to risk, as has been discussed above.[21] SEBI also authorizes FIIs to invest generally in derivatives traded on a recognized stock exchange.[22]

8.2. Country comparisons

India's peers, Brazil, South Korea, South Africa and Turkey, do not have different position limits for foreign investors and domestic participants in their derivatives markets. Furthermore, these nations regulate forwards and futures market as one and do not regulate one or the other differentially.[23]

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receipts may be hedged only after issue price has been finalized; See, *Id.* at (f); To look at a third example, contracts involving rupees as one of the currencies may not be re booked once cancelled except when authorized by the RBI. See *Id.* at (h).

[16] *Id.* at Schedule I, Paragraph B.2 (1)(a)-(d) and (3). These contracts may not involve rupees. There may be no net flow of premiums. The RBI must also approve borrowing in foreign currency. The notional principle amount of the hedge may not exceed the outstanding amount of the foreign currency loan and the maturity of the hedge may not exceed the unexpired maturity of the underlying loan.

[17] *Id.* at Regulation 6 (stating that approval is subject to such terms and conditions as (the RBI) may consider necessary); See, *Id.* at Schedule III. (outlining disclosure requirements, specifically descriptions of business activity and nature of risk, instruments proposed to be used for hedging, names of commodity exchange and brokers, size or tenure of exposure, turnover, and copies of risk management policies that must include risk identification, risk measurements, guidelines and procedures to be followed regarding reevaluation and monitoring of positions, names and designations of officials authorized to undertake transactions and any other relevant information. Units in Special Economic Zones ("SEZ") are exempted from these requirements so long as they are completely isolated from financial contracts with its parent or subsidiary in the mainland or within the SEZ so far as import or export transactions are concerned.)

[18] FEMA Master Circular No. 5/2009-10, (Master Circular on Miscellaneous Remittances from India-Facilities for Residents) Dated 1-7-2009, [hereinafter FEMA Liberalized Remittance Scheme] Issued by Foreign Exchange Department, RBI, at A.13.4.

[19] SEBI Circular No. IMD/CIR No. 7/104753/07, dated 26-9-2007, at Paragraph 2(viii)(What investments would be considered appropriate for purposes of hedging and portfolio balancing are not defined further).

[20] *Id.* at Paragraph 3 (detailing investment ceilings) and Paragraph 4 (stipulating requirements regarding appointing a dedicated fund manager, due diligence, disclosure, investment by existing schemes, reporting to trustees and SEBI, review of performance and prudential investment norms).

[21] FEMA Foreign Exchange Derivative Contracts, *supra* note 1, at Schedule I, Paragraph A.1 and accompanying text.

[22] SEBI FII Regulations, *supra* note 3, at Regulation 15(1)(d).

[23] International Capital and Exchange Market Regulation (2009)(Braz.), *available at* http://www.bcb.gov.br/?RMCCINORMSNORM, ECONOMICS INTELLIGENCE UNIT, COUNTRY FINANCE SOUTH KOREA(2009), Exchange Control Manual (2009)(S.Afr.), *available at* http://www.reservebank.

8.3. Derivatives and balance of payments

8.3.1. *Analysis*

For purposes of capital flows management regulations and the regulation of foreign investment, the working group noted that derivatives trading has minimal balance of payments implications. This is suggested by the cancelling out that takes place with actual cash flows associated with derivatives positions.

When thousands of foreign investors hold positions with a derivatives clearinghouse, on a day to day basis, the only cash movements which take place are those required for the mark-to-market margin. On any given day, some foreign investors will earn positive mark-to-market margin cash flows while other foreign investors will have to pay in mark-to-market margin. *When the number of foreign investors becomes very large, the summation of all foreign mark-to-market margins will tend to zero.*

Hence, derivatives trading has minimal balance of payments implications. Derivatives modify the risk structure of the economy, but on an average day, the net capital moving in or out of the country tends to zero, as long as the number of foreign market participants is large. Policy decisions about derivatives trading as a matter of prudential regulation should then be seen as a separate matter from the regulation of foreign investment.

Derivative products are securities which can be traded independent of a trade in the underlying security or commodity. Even if the underlying security is a foreign security, the derivative product could be a purely Indian security. Trade in such products in India would not lead to any balance of payment implications.

8.3.2. *Recommendations*

In line with our suggestions of the QFI framework and a single window for portfolio investment regulations, the working group suggests that prudential regulation be separated from capital flows management regulations. Policy goals, whether involving financial stability or other matters, should be articulated directly and not in the guise of regulating foreigners. Since derivatives trading has minimal balance of payments implications, capital flows management regulations should focus on spot instruments such as shares and bonds, and not on derivatives.

As such, the working group believes that derivative products with no balance of payments implications should be permitted as a matter of foreign exchange law. Note that the group articulated a general policy preference that the government encourage greater trade in exchange traded in comparison to over-the-counter derivatives.

8.4. The relationship of forwards and futures markets

8.4.1. *Analysis*

Forwards and futures markets should be seen together. Allowing for participation in one route while banning the same in another merely redirects flows, invites regulatory arbitrage and may not have the intended effect. The Tarapore Committee has recommended that spot and forward markets in foreign exchange should be liberalised in a phased manner and extended to all participants without reference to past performance or underlying exposures.[24]

co.za/internet/publication.nsf/WCEV/8B1C8768741BF40C42256C44003331A6/?opendocument, Deutsche Bank, Deutsche Bank Market Guide Turkey(2009).

[24] Report of the Committee on Fuller Capital Account Convertibility 55 (2006).

If anything, there is merit in having a policy bias in favour of the transparent exchange-traded market. The existing Indian capital flows management regulation - where foreign investors can use the Over The Counter ("OTC") currency forward but are prohibited from using the currency futures - is hard to justify.

8.4.2. *Recommendations*

The regulation of futures, forwards and options should be harmonized. The present arrangement, where foreign investors support the non-transparent currency forward market and are blocked from using the transparent currency futures market, is an anomaly. Once again, note that the group articulated a general policy preference that the government encourage greater trade in exchange traded in comparison to over-the-counter derivatives.

8.5. Position limits

8.5.1. *Analysis*

Position limits are about market power. Stated differently, position limits are intended to limit the ability of a market participant to engage in market manipulation. This issue of securities market supervision should be treated in a nationality-neutral way. Regardless of the nationality of a market participant, position limits should be structured so as to reduce the possibility of market manipulation.

Under the present arrangements used in India, foreigners are at a disadvantage. Position limits are articulated at the level of a FII, not at sub-accounts. So those who have sub-accounts are in worse positions. For example, one legal entity may have four FII licenses, yet other sub-accounts would be constrained by an overarching FII position limit.

8.5.2. *Recommendations*

Financial regulation should not have different limits for foreign and domestic participants. Concerns about large positions and market integrity should be articulated directly in policy without having reference to foreigners per se. Under the new QFI framework, there would be not be different position limits for foreign investors and residents.

8.6. Offshore derivatives instruments

8.6.1. *Analysis*

As stated in our earlier discussion of the QFI framework, the working group feels that certainly greater onshore participation facilitates financial stability through the greater ability of regulators to supervise market practices. Yet, there are many reasons for trading in offshore derivative instruments that no national regulatory regime may be able to completely suppress.

For example, many investors may want to structure sector baskets covering stocks in many different markets or may not want to run the direct operational risk of stock trading in markets directly. Furthermore, there may be little correlation between the amount of offshore derivative instruments and inflows and outflows from Indian securities markets because hedging and risk management tools have advanced well beyond simple delta one products. The Tarapore Committee, which noted that "it

is also not possible to prevent trading in PNs (participatory notes)" to the extent that Indian regulators do not have the jurisdiction to restrain foreign entities from issuing such notes on the strength of securities held by them.[25] Pursuant to our recommendations, the working group notes that SEBI would have the final right to demand details about the end investor in cases of needed investigations, though the group is cognizant of the limited reach and power of regulation here.

8.6.2. *Recommendations*

As discussed in the context of our proposed QFI framework, streamlining registration processes with international standards could also reduce the incentives to participate in markets such as those for participatory notes, though there are structural reasons why such trade is unlikely to completely stop.

8.7. Outflows: Indian residents trading in derivatives abroad

8.7.1. *Analysis*

Limitations on Indian residents investing in derivatives trade abroad appear rooted in consumer protection concerns and on a general level, broad or general concerns about the country's image. However, to the extent that Indian economic agents are able to modify their risk exposure by voluntarily entering into overseas derivatives transactions, this would be beneficial for India.

8.7.2. *Recommendations*

For Indian residents investing in derivatives trade abroad, the working group suggests that investment up to the US$200,000 limit under the LRS be exempt from further regulation. In particular, the working group recommends the consumer protection guidelines for outflows articulated in earlier chapters be applied to the marketing within Indian territory of all investment opportunities, including derivatives investments, abroad. Persons choosing to invest in derivatives abroad should bear the risk of their trades, though any conversation with investors within India regarding derivatives investments should be governed by retail consumer protection regulation. The ban on taking margin payments should also be revised to allow such payments provided that total liability, not simply the margin account, does not exceed the LRS cap.

[25] *Id.* 143 (2006).

8.8. Annexure

8.8.1. *Capital flows management regulations*

Derivatives

Inflows	FII	NRI	CORPORATES	INDIVIDUAL
Currency	2	2	1 | FDI	1 | FDI
Equity	5	5	1	1
Commodity	1	1	1	1
Fixed Income	1	1	1	1
Exotic	2	2	1	1

Outflows	INDIVIDUAL	MUTUAL FUNDS	BANKS	PENSION FUNDS	INSURANCE FUNDS	CORPORATES
Currency	2	2	2	1	1	2
Equity	1	2	1	1	1	1
Commodity	3	1	1	1	1	3
Fixed Income	1	1	2	1	1	1
Exotic	1	1	1	1	1	1

KEY	Complete Ban			Fully Open
1	2	3	4	5

8.8.2. *BSST countries: Derivatives*

		India		Brazil		South Korea		South Africa		Turkey	
		Inflows	Outflows	Inflows	Outflows	Inflows	Outflows	Inflows	Outflows	Inflows	Outflows
Investor type differentiation		**1**	**1**	**0**	**1**	**0**	**1**	**1**	**0**	**0**	**0**
Quantitative restrictions	Level	**0**	**0**	**0**	**0**	**0**	**0**	**0**	**1**	**0**	**0**
	Percentage	**0**	**0**	**1**	**0**	**0**	**0**	**1**	**1**	**0**	**0**
Taxation measures		**1**	**1**	**1**	**0**	**0**	**0**	**0**	**0**	**0**	**0**

Note: 1 = Yes, 0 = No.

CHAPTER 9

Tax

Tax concerns are an integral part of investment decisions. As a practical matter, the tax treatment of a given investment structure can play a significant role in determining the viability of these vehicles and whether investments are made. Capital account policy decisions, whether for greater liberalization or increased management of capital flows, need to also include an appropriate taxation framework in order to achieve the intended policy outcomes.

The working group had broad-ranging discussions about the appropriate framework for foreign investment and tax policy. In this light, the first section of this chapter presents the working group's thinking on first principles in tax policy and foreign investment. Any discussions of first principles in tax involve global residency-based taxation versus India's current *de jure* (though not *de facto*) system of largely determining taxation based on source. While neither India's nor any other nation's system of taxation can be placed cleanly into one category or another, the working group highlighted the economic rationale and conceptual underpinnings behind discussions of particular tax measures. While making no actionable recommendations on these broad policy matters beyond further studies, the group offers a framework for rethinking tax policy and foreign portfolio investment given India's current level of integration into the world economy. The second area discussed in this chapter is the interplay between 'permanent establishment' issues and the fund management industry, with the twin issues of achieving a deep engagement with international capital and with achieving a vibrant onshore fund management industry.

9.1. Achieving tax neutrality for financial products and services

A core principle guiding discussions on tax policy and globalisation is that taxation should not generate distortions which influence the economic decisions of individuals or firms. Taxation should be neutral and neither generate a bias in favour of doing business at home nor a bias in favour of doing business abroad. Tax neutrality as regards trade in goods and services has been achieved by focusing taxation purely upon the point of consumption through the destination principle. Under the VAT system, a British consumer of an Australian shirt only pays VAT in Britain. The global market for shirts is fully competitive: all high seas prices are free of taxation. The VAT system actively participates in the process of achieving neutrality, by refunding the entire burden of domestic taxation that was faced by the exporter. While this system is relatively easy to operationalise for destination based consumption taxes on

goods, complexities arise when it is attempted with regard to financial services. By and large, this approach of focusing taxation upon residents has delivered high levels of current account integration in the world economy without tax-induced distortions of behaviour.

Similar issues arise in the treatment of capital account integration. Internationally, two systems exist for taxing capital gains on financial products. In the first system, a country taxes such gains in the case of *residents* but exempts them from tax in the case of non-residents. Consequently, while determining the distribution of rights of taxation of such gains between countries, the country where the capital gains have occurred (source country) cedes the rights of taxing capital gains of non-residents to the other country. This is known as a 'residence based system'. It is based on the principle of "capital export neutrality" which means that the investor pays the same domestic and foreign taxes, irrespective of source of investment income, local or foreign. Most of the developed countries largely follow this system, though there are certain small deviations in certain cases.

In the second system, a country taxes such gains in the case of residents as well as non-residents. Consequently, while determining the distribution of rights of taxation of such gains between countries, the country where the capital gains have occurred (source country) does not cede the right of taxing capital gains of non-residents. The non-resident can claim credit for taxes paid in the source country in his country of residence. This is known as a source based system. It is based on the principle of capital import neutrality which means that capital funds invested in various countries should be equally taxed, regardless of investor domicile. Most developing countries, including India, follow this system.

Under a residence-based tax system, the global market for financial services is undistorted by tax considerations to the extent that the investor does not have to take into account the tax regime of the source country. The British buyer of an Australian financial product only pays income tax in the UK. This delivers the end result of global competition and freedom of choice. The UK tax authorities tax the global financial services income of UK residents and the Australian tax authorities tax the global financial services income of Australian residents. Theoretically, the same result could be achieved in a pure source based taxation system for financial services as the investor would be taxed only in the source country and not in his country of residence which would exempt such income. However, in practice, since all major capital exporting OECD countries follow a residence based taxation regime, the discussion which follows is based on the *de facto* situation that most global capital is sourced from residence based tax regimes.

While a mechanism to obviate taxes paid in the source country exists under the source based mechanism through a system of double taxation avoidance agreements with residence based taxation regimes, it is automatic in the residence based taxation regime as the non-resident is not taxed at all. This leads to ease of operations if a purely residence based system is adopted for taxing portfolio capital gains. A non-resident global investor would prefer to invest in a country with a residence based taxation regime because he is not taxed in the source country, so his entire income (domestic as well as foreign) is taxed only once in his country of residence. In contrast, under the source based system he would pay tax in the source country and would have to seek credit for such taxes in his home country. This raises his compliance burden and may not even fully mitigate the tax burden in all cases if the tax rate in the source country is more than the rate he faces in his home country.

Globalization has brought about instantaneous mobility of capital. The presence of tax havens and the ease with which investment vehicles can be incorporated there, allows shifting of capital to such tax havens. This hampers the ability of countries to

tax capital gains of their high net worth residents. All countries who follow a residence based system are struggling with the challenge of 'double non-taxation' i.e taxing the capital gains and other passive incomes which may be coming from tax havens. A source based system with moderate tax rates ensures protection of the country's tax base to the extent that both residents and non-residents pay taxes on capital gains and there is no tax incentive for residents to 'round-trip' their funds through non-resident investment vehicles incorporated in tax havens. The mainstream OECD practices have involved starting from a residence-based foundation of the tax system coupled with a series of specific enforcement efforts aimed at reducing losses of revenues on account of tax havens.

Traditionally, developing countries who have had source-based taxation have sought to reduce the compliance and tax burden by

1. Creating a separate low tax regime for capital gains on financial products in the case of non-residents, or
2. Keeping a low tax regime for capital gains on financial products in the case of non-residents as well as residents, or
3. Ceding the right to tax capital gains on portfolio investment of the non-resident to his home country through a double tax avoidance tax treaty with specific countries.

India has engaged in this approach to some extent by special treatment of FIIs investing from some specific tax jurisdictions. In recent years, with increased economic integration, source-based taxation may create a number of second best policy outcomes for the Indian economy when it comes to the competitive positioning of the onshore financial system in competition with offshore India-related financial activities. For example, foreign investors have a choice between trading shares of Infosys at the National Stock Exchange ("NSE"), or the Bombay Stock Exchange ("BSE"), as opposed to trading a American Depository Receipt ("ADR") in New York. New York has residence based taxation while Mumbai (India) does not. For foreign investors, this generates a bias in favour of not sending the order to Mumbai. Similar issues would arise in the trading of other financial products like futures, Indian Depository Receipts ("IDRs") or currency derivatives.

In all these areas, attempts to obtain tax revenues from the financial activities of non-residents in India, will (all things being equal) induce a reduced level of activity in domestic financial markets, and favour overseas market venues. Source based taxation results in reduced market liquidity and thus reduced market efficiency. A future shift towards a residence-based system could thus be one of the components of India's financial reform.

On the other hand, following a residence-based taxation for capital gains raises the dilemma of "round-tripping" by residents and the country losing its capital gains tax base. The proposed Direct Tax Code now seeks to introduce GAAR and CFC provisions which have been used by OECD countries to ensure, among others, tax compliance by their residents with regard to global income.

9.2. Country Comparisons

As with the other chapters of this report, we compare Indian conditions against the four 'BSST' peer emerging markets: Brazil, South Africa, South Korea and Turkey:

- The Brazilian taxation of capital gains from portfolio investments is largely residence based barring some issues with withholding tax;

- South Korean taxation is also residence based taxation barring some issues with withholding tax;
- Turkey has moved to a residence based system of taxation as part of their desire to join the European Union;
- South Africa is in the process of shifting from a source-based to a residence-based system.

9.3. Problems of permanent establishment

9.3.1. *What is "PE?"*

Defined variously in treaties and national statutes, the term "permanent establishment" or "PE" refers to a fixed place of business through which the business of an enterprise is wholly or partly carried on.[1] The determination that a person resident in one country has a "permanent establishment" in another opens that residents business to taxation in the other country. PE as a concept originated in the Industrial Law of 1845 in Prussia. There is no definitive test for determining what constitutes a permanent establishment. This is typically a fact-based assessment.

There are many different avenues through which permanent establishment can be established. PE can include "Fixed Place PE" for assessing tax liability where a fixed location is involved, "Agency PE" for determining tax liability where agency relationships such as with brokers are involved, "Installation PE" for when building sites, construction or installation projects are involved, and "Service PE" for a non-resident providing services through employees or other personnel.

With regard to PE, the working group focused narrowly on tax law obstacles to fund managers locating, developing practices and contracting secondary services in India. Under Indian contract law, agency relationships sufficient to constitute a permanent establishment can be created through assessments of express or implied authority, ratification, ostensible authority or necessity. The primary test for determining such a relationship is the legal ability of the agent to bind the principal to a third party.[2] Permanent establishment status does not apply to agents found to be independent. A finding that an agent is dependent will lead to recognition of a permanent establishment and tax liability. Dependent agents include those who act on behalf of the enterprise and who have authority to conclude contracts. Permanent establishment would not be found if an independent agent is acting in the ordinary course of business. Permanent establishment also only applies to activities in the country which the agent undertakes for the business.

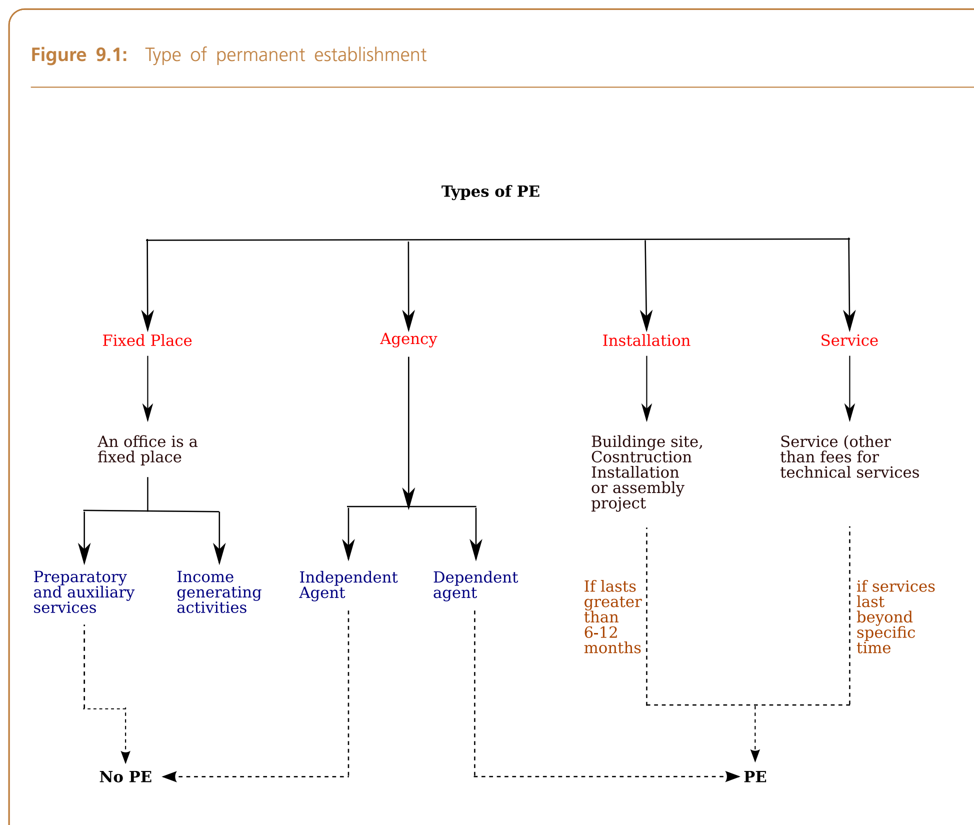
Determination of whether an agency relationship, such as with fund managers, is created, is fact specific. Tax authorities look at factors whether an actor processes and delivers services directly to a customer, attendance and participation in negotiations and other measures of the extent and nature of involvement of the actor.

Where the activities of the fund manager are construed as constituting a PE for the global fund in India, the global fund and consequently the ultimate investors in the global fund, could suffer taxation in India that is more adverse. Further, at this level of taxation, a situation could also arise that the ultimate investors in the global

[1] Organisation for Economic Co-operation and Development, Model Convention with Respect to Taxes on Income and on Capital, Jan. 28, 2003. Art 5 [hereinafter OECD Model Tax Convention], §1; *See*, Agreement between the Government of India and the Government of Greece for the avoidance of double taxation of income, India-Greece, art. 2.(h), 11th February, 1965, and UK/India Double Taxation Convention, India-U.K., art. 5, 25th January, 1993.

[2] Prussia and the Austro-Hungarian Empire created the first modern double taxation avoidance agreement in 1899. STEF VAN WEEGHEL, THE IMPROPER USE OF TAX TREATIES 27 (1970).

Figure 9.1: Type of permanent establishment



fund are unable to claim a credit for taxes paid in India against their tax liability in their home jurisdiction since the Indian tax on their income may exceed tax on this income in their home jurisdiction. To mitigate the risk of such adverse taxation, global funds will seek to contract with fund managers based in jurisdictions whose taxation laws would not produce such a taxing outcome.

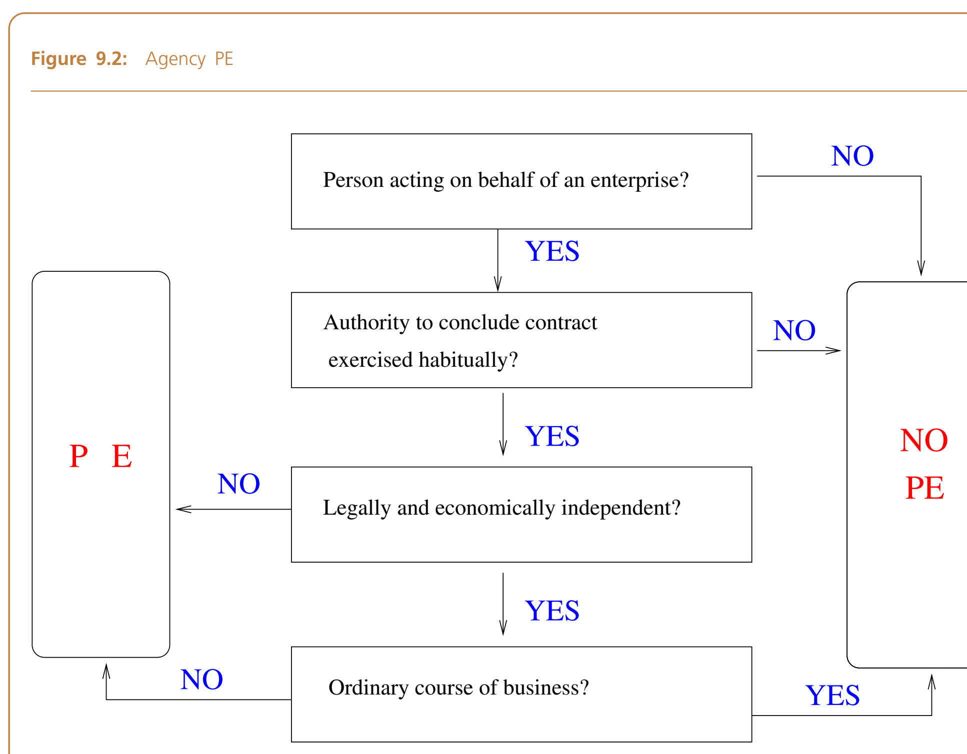
9.3.2. *Analysis: The issue of PE and fund management from India.*

The working group discussed whether the likelihood of fund managers' presence in India serving to create a permanent establishment and tax liability has driven many financial services providers to locate their India-investment services in locations like Singapore. The following issues merit attention:

1. When foreign fund managers build a fund management establishment in India, this leads to a greater knowledge about India and Indian firms. This deep engagement with India yields reduced asymmetric information, and helps avoid the pathologies of international financial integration such as herding, capital flow reversals, etc. Indian macroeconomic stability is thus assisted by a greater presence of fund management establishments in India which manage global assets invested in India;

2. When foreign fund managers choose to locate outside India, there is a potential loss of tax revenue to India which would otherwise have come from the enhanced income of the fund management from offering the services out of India. To the extent that fund management establishments in India perform functions going beyond India - e.g. some firms may choose to place their Asia-scale fund management in Bombay - this could potentially yield increased tax revenues;

Figure 9.2: Agency PE



A Revised Discussion Paper on the proposed Direct Taxes Code[3] examining FII investments in permitted securities notes that:

> "(t)he majority of FIIs are reporting their income from such investments as capital gains. However, some of them are characterizing such income as "business income" and consequently claiming total exemption from taxation in the absence of a Permanent Establishment in India. This leads to avoidable litigation. It is therefore, proposed that the income arising on purchase and sale of securities by an FII shall be deemed to be income chargeable under the head "capital gains." This would simplify the system of taxation, bring certainty and is easy to administer."

If enacted, under this proposal, the activity of fund managers would not risk the recognition of a permanent establishment. The DTC, if enacted in its current form, would then remove this barrier to the development of financial services in the country.

This would make a significant difference to the issues of permanent establishment in fund management as a permanent establishment only gets created in relation to business income (and not capital gains). This proposal needs to be broadened to cover all non-residents going beyond FIIs.

9.4. Recommendations

As India further integrates into the world economy, the country may need to evaluate present policies of source-based taxation of capital gains. Integration into international finance requires not applying a burden of taxation upon non-residents. The working group is aware that a shift to a residence-based taxation would mark a substantial shift in Indian tax policy including tax treaties. As has been discussed, there

[3] REVISED DISCUSSION PAPER. DRAFT DIRECT TAXES CODE Paragraph 3.5 (2010) *available at* http://finmin.nic.in/dtcode/RevisedDiscussionPaper.pdf [hereinafter DTC].

are some undeniable benefits of a source based taxation model for capital gains. The working group also acknowledges that a shift in the basis of taxation extends far beyond the realm of financial services, should not be taken lightly and requires further study. For the moment, the working group recommends that the Ministry of Finance embark on technical studies aiming to shed light on:

1. The revenue implications of shifting to a residence-based system of taxation;
2. The information technology systems and information sharing mechanisms with other countries which need to be in place to properly implement taxation of global income of residents in a residence-based taxation system for capital gains. A study of such mechanisms in BSST and OECD countries could be done;
3. The administrative issues and short-term revenue implications of shifting from a source-based to a residence-based system with attention to other countries experiences with such transitions;
4. The revenue and compliance advantages of source based taxation of capital gains and whether tax and compliance burden would actually reduce if countries followed a source based taxation regime for capital gains.

The working group recognises that the DTC along with the Revised Discussion Paper, if enacted in its present form, improves certainty on the question of permanent establishment for FIIs. The proposal to deem income of FIIs as income from capital gains should be broadened to cover all non-resident investors including private equity funds.

Further, a broader approach could also be considered so that fund managers become comfortable with offering financial services from Indian soil, for India-related and for global-scale fund management. For this, there needs to be clarity regarding the circumstances under which a fund manager in India handling the investments of a global fund located abroad would be held to be an "independent agent" and consequently would not constitute a PE in India. A suitable instruction or circular laying down the criteria to be used to determine 'dependent" and "independent" agent status in the case of fund management services for global investors would provide a degree of certainty and would help in increasing fund management and advisory services out of India.

CHAPTER 10

Tables

10.1. List of abbreviations

1. Advance Pricing Arrangements ("APA's")
2. American Depository Receipts ("ADR")
3. Anti-Money Laundering ("AML")
4. Anti-Money Laundering/ Combatting Terrorist Finanancing ("AML/CFT")
5. Annual Report on Exchange Arrangements and Exchange Restrictions ("AREAER")
6. Asian Development Bank ("ADB")
7. Brazil, South Africa, South Korea and Turkey ("BSST")
8. Central Board of Direct Taxes ("CBDT")
9. Certificates of Deposits ("CD's")
10. Credit Information Companies ("CIC")
11. Delivery Versus Payment-1 ("DVP-1")
12. Department of Industrial Policy and Promotion ("DIPP")
13. Department of Revenue and Department of Economic Affairs ("DEA")
14. Depository Participants ("DPs")
15. Domestic Venture Fund ("DVF")
16. Double Taxation Avoidance Agreements ("DTAA's")
17. Draft Direct Taxes Code ("DTC")
18. External Commercial Borrowings ("ECB")
19. Financial Action Task Force ("FATF")
20. Financial Services Authority ("FSA")
21. First-in-first-out ("FIFO")
22. Foreign Currency Convertible Bonds ("FCCB")
23. Foreign Currency Exchangeable Bonds ("FCEB")
24. Foreign Direct Investment ("FDI")
25. Foreign Exchange Management Act ("FEMA")
26. Foreign Institutional Investor ("FII")

27. Foreign Investment Promotion Board ("FIPB")
28. Foreign Vencture Capital Investor ("FVCI")
29. Forward Contracts (Regulation) Act ("FCRA")
30. Forwards Market Commission ("FMC")
31. Global Depository Receipts ("GDR")
32. Government of India ("GoI")
33. Gross Domestic Product ("GDP")
34. High Powered Expert Committee ("HPEC")
35. Income Tax Act ("IT Act")
36. Indian Depository Receipts ("IDR")
37. Information Technology ("IT")
38. Insurance Regulatory and Development Authority ("IRDA")
39. International Organisation ("Int. Org.")
40. Joint Venture or Wholly Owned Subsidiary ("JV/WOS")
41. Know Your Client/Customer ("KYC")
42. Liberalised Remittance Scheme ("LRS")
43. Limited Liability Partnerships ("LLPs")
44. Market-Wise Position Limit ("MWPL")
45. National Stock Exchange ("NSE")
46. Non-Banking Financial Companies ("NBFC")
47. Non-Convertible Debenture ("NCD")
48. Non-deliverable forward ("NDF")
49. Non-governmental organisation engaged in microfinance activities ("MFI")
50. Non-resident External ("NRE")
51. Non-Resident Indian ("NRI")
52. Non-Resident Non-Repatriable or Non-Resident Special Rupee ("NRSR")
53. Non-resident Ordinary ("NRO")
54. Organisation for Economic Co-operation and Development ("OECD")
55. Overseas Corporate Bodies ("OCB")
56. Overseas Direct Investment ("ODI")
57. Participatory Notes ("P-notes")
58. Pass Through Certificates ("PTC's")
59. Pension Fund Regulatory and Development Authority ("PFRDA")
60. Permanent Account Number ("PAN")
61. Permanent Account Number ("PAN")
62. Permanent Establishment ("PE")
63. Persons of Indian Origin ("PIO")
64. Prevention of Money Laundering Act ("PMLA")
65. Private Investment in Public Equity ("PIPE")
66. Public Sector Undertakings ("PSU")
67. Qualified Financial Investors ("QFI")

68. Qualified Institutional Buyers ("QIB's")
69. Qualified Institutional Placement ("QIP")
70. Real Estate Investment Trusts ("REIT")
71. Real Time Gross Settlement ("RTGS")
72. Reserve Bank of India ("RBI")
73. Secretariat for Industrial Assistance ("SIA")
74. Securities and Exchange Board of India ("SEBI")
75. Securities Appellate Tribunal ("SAT")
76. Securities Transaction Tax ("STT")
77. Singapore Exchange ("SGX")
78. Special Economic Zones ("SEZ")
79. Special Purpose Vehicle ("SPV")
80. Suspicious Transaction Report ("STR")
81. U.S. Producer Price Index ("PPI")
82. United Kingdom ("UK")
83. United Progressive Alliance ("UPA")
84. Value Added Tax ("VAT")
85. Venture Capital Fund ("VCF")

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