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RATIONALISING SCOPE OF FOREIGN DIRECT INVESTMENT AND PORTFOLIO INVESTMENT

1. Background

A foreign investor can choose from different routes for investment in India, subject to compliance with eligibility conditions and other requirements. These routes consist of foreign direct investment (FDI), portfolio investment (PI), investment by foreign venture capital investor (FVCI) and investment by qualified foreign investor (QFI). The PI route is available to foreign institutional investors (FII) and non-resident Indians (NRI).

Over the years, these routes have developed into complex web of rules and regulations that are, at times, overlapping and contradictory. This has created problems of regulatory arbitrage and lack of transparency, culminating in increase of transaction costs for investors and increased cost of capital for Indian entities.[1] The unavoidable resemblance between investment objectives of FIIs, NRIs and QFIs has blurred the dividing line between such routes and has escalated the confusion within the non-FDI route. In addition, the perceived dissimilarity between FDI and PI routes has also fueled the demands for clarifying scope of FDI and PI.

This note explores the possibility of clearly distinguishing, rationalising and de-mystifying the scope of different modes of foreign investment. As indicated, the two principle issues dealt with in this note are distinction between FDI and PI; and rationalisation of investment routes, specifically the non-FDI route.

2. Distinguishing FDI from PI

2.1. *Introduction*

The Consolidated FDI Policy issued by the Department of Policy and Promotion (DIPP) provides a high level-principle based distinction between FDI and PI, as former having the connotation of establishing a 'lasting interest' in an enterprise that is resident in an economy other than that of the investor.[2] However, concerns have arisen about actual implementation of such distinction on account of ambiguous interpretation of the term 'lasting interest' and possibility of its creation by portfolio investors, amongst other reasons.

2.2. *International experience*

DIPP has borrowed its differentiating principle from OECD[3]. IMF has also adopted the OECD definition with some modifications.[4] While OECD focuses at the 'lasting interest objective' of

[1]Report of Working Group on Foreign Investment in India, 2010
[2]Paragraph 1.1.1 of the Consolidated FDI Policy
[3] THE OECD Benchmark Definition of Foreign Direct Investment, (Fourth Edition, 2008) defines direct investment as a category of cross-border investment made by a resident in one economy (the direct investor) <u>with the objective</u>

the investor, IMF examines existence of 'control or a significant degree of influence on management' of the investee. Both OECD and IMF recognise existence of 'lasting interest' or 'significant influence', as the case may be, on ownership of at least 10 percent voting power in the investee (known as, direct investment enterprise).

While OECD and IMF acknowledge that in practice there may be several factors which determine the influence a direct investor has over the direct investment enterprise, for the sake of consistency, cross-country comparability of the FDI statistics, and to avoid subjective judgments, they recommend a strict application of the numerical guideline to define direct investment.

OECD takes a step further and specifically states that it does not recommend the use of other considerations such as representation on the board of directors; participation in policy-making processes; material inter-company transactions; interchange of managerial personnel; provision of technical information; and provision of long-term loans at lower than existing market rates. Interesting to note is that India currently uses[5] (and has proposed to use[6]), the tests of the right to appoint majority of directors, amongst others, to measure control. Countries such as South Korea[7] use similar tests to determine foreign investment. However, several countries such as Turkey[8] and South Africa (for outward investment[9]) have incorporated the 10 percent test in their respective statutes.

2.3. *Domestic experience*

Several regulations govern foreign investment in India. Following key distinctions between FDI and PI can be deduced from such regulations.

S. no	Condition	FDI	PI	Key derivations
1.	Eligible investors	• Persons resident outside India. • Entities incorporated outside India (including FIIs). • NRIs.	• FIIs and their sub-accounts. • NRIs.	Persons eligible to invest through FDI route include, but are not limited to FIIs and NRIs. PI route is available to these two categories only.

of establishing a lasting interest in an enterprise (the direct investment enterprise) that is resident in an economy other than that of the direct investor.

[4]The IMF Balance of Payments and International Investment Position Manual (Sixth Edition, 2009) defines direct investment as category of cross-border investment associated with a resident in one economy having control or a significant degree of influence on the management of an enterprise that is resident in another economy.

[5]The Consolidated FDI Policy (April 2013); SEBI (Substantial Acquisition of Shares and Takeovers) Regulations, 2011; Companies Act, 1956

[6]The Companies Bill, 2012

[7] The Foreign Investment Promotion Act, 1998, defines foreign investment to include purchase of stocks for the purpose of establishing a continuous relationship with and participating in the management of said Korean corporation.

[8]Foreign Investment Law no. 4875

[9]South Africa Exchange Control Manual

S. no	Condition	FDI	PI	Key derivations
2.	Modes of payment	• Inward remittance through normal banking channels. • Debit to specified accounts. • Conversion of royalty/ lump sum/technical know-how fee/external commercial borrowings. • Conversion of import payables (including capital goods)/pre incorporation expenses/ share swap.	• FIIs – Investments from specified accounts. • NRIs – Inward remittance through normal banking channels or debits to specified accounts.	Existence of bank account is not necessary in certain FDI transactions, due to possibility of non-monetary consideration.
3.	Investment limits	Sector specific limits. These limits usually range from 26 percent to 100 percent. However, certain limits are inclusive of investment through non-FDI route (PI route/ investment by FIIs/ NRIs).	• Individual FII/sub-account – 10 percent of the total paid up capital. <u>The 10 percent limit includes securities acquired through FDI as well as PI route.</u> • Aggregate holding of all FIIs/sub accounts – 24 percent of the paid up capital. This limit can be increased to sectoral cap/statutory ceilings, subject to compliance with certain conditions. • Individual NRI – 5 percent of the paid up capital. • Aggregate	• FDI as well as PI route contemplates investment between 0 percent – specific outer limit. <u>Consequently, lack of clarity persists on whether FII investment between 0 – 10 percent and NRI investment between 0 – 5 percent, is to be considered FDI or PI.</u> • Ambiguity exists if FDI and PI limits are exclusive, inclusive or require aggregation. • Doubts remain over what constitute "sectoral cap/statutory ceiling", for raising of aggregate FII limit. • Confusion prevails if NRI limit is

S. no	Condition	FDI	PI	Key derivations
			holding of all NRIs – 10 percent of the total paid up capital. This can be raised to 24 percent subject to compliance with certain conditions.	exclusive or inclusive (like FII) of investment via FDI route. • Concerns have also arisen on limiting aggregate FII/NRI holing – it is akin to putting presumably different investors in one basket.
4.	Reporting requirements	• Reporting obligation on Indian entity. • Reporting of inflows required. • Reporting of issue of securities required, along with necessary certifications/transfer of shares.	• FIIs – Reporting obligation on authorised dealers (for transfer of funds) as well as Indian company (for issue of securities). • NRIs – Reporting obligation on authorised dealers.	Where bank account exists, confirmation of transfer of funds is required from authorised dealer. Confirmation of issue/ transfer of securities are required from the Indian entity.

Consequently, while India has not blindly copied the IMF/OECD recommendations on FDI-PI distinction, it has, like several other countries, customised such recommendations to suit its requirements. Such modifications might have been prompted by and served the needs of the times they were made; however, absent an in-depth need-based review has led to various ambiguities that have inflated transaction costs and cost of capital.

Although there is an urgent need to clarify and rationalise the FDI-PI expanse, CUTS firmly believes that reviewers must resist the temptation of following internationally recommended approach, without conducting a detailed need-based analysis, guided by high-level principles and evaluating possible alternatives.

As the distinction between FDI and PI is expected to prompt differences in level/rigorousness of regulation and consequently impact transaction costs, it needs careful examination.

2.4. *Guiding principles*

Various studies indicate that the motivation to significantly influence or control an enterprise is the underlying factor that differentiates direct investment from cross-border portfolio investments. For the latter, the investor's focus is mostly on earnings resulting from the acquisition and sales of shares and other securities without expecting to control or influence the management of the assets underlying these investments. It is believed that direct investment relationships, by their very nature, may lead to long-term and steady financing and technological transfers with the objective of maximising production and the earnings of the investee over time. Portfolio investors do not have as an objective any long-term relationship. Return on the assets is the main determinant for the purchase or sale of their securities.

Another distinguishing feature is the emphasis of PI on negotiability of securities which is a way of facilitating trading, allowing them to be held by different parties during their lives. Negotiability allows investors to diversify their portfolios and to withdraw their investment readily.

Consequently, while FDI is considered long-term stable investment that brings expertise and technology, PI is considered short – term volatile investment with the objective of obtaining quick returns. While being contestable[10], such assumptions must lead to differential regulation between FDI and PI, former being subject to lighter regulation than the latter. If, however, it is concluded that no concrete difference exists in the behaviour of FDI and PI flows, and as a result no two sets of regulations are required, it may well be advisable to adopt the IMF/OECD recommendations for the sake of consistency and to enable international comparison.

2.5. *Possible alternatives*

In light of aforesaid discussion, CUTS suggests following possible alternatives to distinguish FDI and PI.

2.5.1. *A numerical guideline*

This suggestion is similar to OECD/IMF recommendation, solitary difference being possibility of adopting a different numeral. Indian regulators have long been comfortable with recognising 'significant influence' on ownership of at least 20 percent of the total share capital in a company.[11] In light of objectives of FDI to exert 'significant influence/ control' in investee, such line of distinction might be adopted between FDI and PI.

2.5.2. *The tautological test*

As the name suggests, FDI is expected to be 'direct' investment by investor into investee. Similarly, use of conduit/intermediary/investment vehicle between investor and investee, with the possibility of creation of 'portfolio' by pooling of funds (from different investors) for investment, denotes PI. Consequently, investments via intermediary without existence of a direct

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[10] C. Rangarajan, *Some Issues in Regulation and Capital Flows,* September 2011, NISM, Mumbai.
[11] Accounting standards (particularly AS 18) issued by ICAI; the proposed Companies Bill, 2012

relationship between investor and investee could be classified as PI and the remaining being considered direct investment.

2.5.3. *Existence of a bank account*

As mentioned earlier, presence of bank account is not necessary for a FDI transaction principally due to possibility of non-monetary considerations. Non-monetary considerations typically consist of technology transfer/transfer of capital goods/share swaps/royalty payments. Such transactions usually denote long term partnership between investor and investee and thus fall under the ambit of FDI. Consequently, it is suggested that such transactions be exclusively clubbed under the domain of FDI. All remaining transactions operated by transfer of funds through bank accounts could be classified as PI.

Use of bank accounts is also important from the perspective of supervision and reporting. When bank accounts are involved, authorised persons (usually the respective banks) are required to confirm transfer of funds and compliance with applicable norms. Such obligation is on the Indian party to transaction when no bank account is involved. Portfolio transactions, considered to be unstable and volatile, and predictably subject to stricter regulations, require greater monitoring and supervision. Presence of authorised dealers as front-line sub-regulators not only assists in efficient regulation but also helps in reduction of transaction time as a result of increased accessibility to regulators.

Considering these factors, utilisation of bank account might be considered as distinguishing feature between FDI and PI.

2.5.4. *Self-declaration test*

As noted earlier,[12] it is difficult to distinguish FDI from PI on the basis of presumption of stability of investment or influence on management. The investor itself is best suited to determine if its investment is direct or not. Consequently, it might be left to the investor to classify the investment. However, such approach requires greater regulatory scrutiny and supervision to confirm authenticity of investor's claim. In case the transaction declared as FDI does not result in creation of lasting interest and proves to be volatile or unstable, strict sanctions would need to be imposed on the parties to maintain sanctity of distinction.

2.5.5. *Progressive relaxation approach*

This approach is based on assumption that FDI is long term and stable and PI is not. Consequently, a portfolio investor is expected to liquidate its holdings much sooner than a direct investor. Based on these assumptions, a set of regulations may be developed that diminishes the regulatory burden on the investment with the passage of time. In other words, the entry level

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[12]"*While portfolio flows can fluctuate from year to year, very rarely does the stock get reduced. Net negative flows during a year are uncommon. It however happened in 2008-09 in India….Adding up across October, November and December 2008 (period worst affected by the financial crises) the overall net sale by foreigners amounted to 6 per cent of their holdings at the end of Sept. 2008. Thus even in the worst scenario, the outflows have been modest*", as noted by Dr. C. Rangarajan.

scrutiny for FDI and PI would be the same, however, longer the investment remains (or the better it behaves!), lesser the norms and regulatory scrutiny it would be subject to.

2.5.6. *Dual-calculation policy*

As highlighted earlier, IMF and OECD have urged strict compliance with its recommendations in the interest of comparability and consistency. However, irreconcilable differences might exist (and currently do exist) between such recommendations and a country's regulatory approach to FDI-PI distinction. Consequently, a case exists for adopting the OECD/IMF recommendations for calculation/comparable purposes while preserving, without substantial tweaking, the present regulatory approach. This would put additional burden on regulator, tasked with management of two-data sets for same information, but might be worthy in the interests of international comparison and consistency.

3. Rationalising multiple non-FDI routes

3.1. *Introduction*

Some of the non-FDI routes, as exist today, are products of liberalisation and consequently, demands of the times they were conceptualised in and promulgated. Liberalisation allowed foreign investors to invest in India and partake in the benefits of its rapidly expanding economy. It was expected that Indian firms would be benefitted by reduced cost of capital and availability of alternate source of finance.

However, absence of a systematic regulatory review of relevance and effectiveness of such different routes have, in recent times, prompted financial sector experts to opine that such routes have now crossed their use-by date, and consequently, should be discarded.

3.2. *Need for multiple routes*

The opening up of Indian economy saw introduction of the FII route of investment in India.[13] In order to push FII investment, FII investors have been granted certain taxation relaxations, such as, lower withholding tax requirements.

In addition, the NRI route, introduced as an initial step towards liberalisation, aimed at encouraging the expatriate Indians to invest in Indian entities, by providing certain benefits, not available to other investors, like certain direct investment relaxations.

Similarly, FVCI route was introduced to encourage investments in non-listed entities and start-ups. FVCIs are provided exemptions from pricing guidelines and lock-in requirements.

The objective of patronising non-FDI routes was availability of alternate source of finance at low cost of capital for Indian entities. However, evidence suggests that benefits of reduced cost of capital are mostly confined to the largest Indian firms. Increased transaction costs, regulatory

[13] Guidelines for Foreign Institutional Investors, Department of Economic Affairs, Ministry of Finance, Press note dated September 14, 1992.

ambiguities, multiple supervisory agencies, and such other weaknesses in the regulatory regime have given large firms a competitive advantage and handicapped smaller firms which have been unable to break through the home bias of foreign investors.[14]

To take another example, in the early stages of liberalisation, NRIs were granted certain benefits to encourage investment. With further opening up of the economy, FII investment limits surpassed the investment limits of NRIs; however, NRI investment limits were not revised. Owing to dissimilarities in investment limits between NRIs and FIIs, FIIs involving NRI participants as sub-accounts are required to create complex structures to monitor investments on behalf of such NRI sub-accounts. This creates disincentives to FIIs for allowing such NRI participation.[15] Experts have noted that there are a number of restrictions, like NRI investment limits, that date to a period of more restrictive regulation and those should be removed before liberalisation can become meaningful.[16]

However, regulatory inaction has not dissuaded experts from evaluating efficiency of foreign investment norms and recommending changes. QFI route was one such recommendation. The QFI model was expected to be a single window registration and clearance platform for all non-FDI investor classes. However, it was introduced as an additional mode of foreign investment with the objective of targeting investors not registered as FIIs or FVCIs. The report of FSLRC also recognised this and recommended creation of a single unified framework for foreign investment in India.[17]

3.3. *Suggested framework*

On a closer scrutiny of different modes of non-FDI investment, one realises that while there is merit in integrating FII, NRI and QFI into one single investment vehicle, FVCIs have been historically treated differently from all other modes of foreign investment. The extent of risk taken by FVCI and consequently the kind of exemptions provided to FVCIs are not found anywhere else.

In addition, the intention of FVCIs seems to provide initial start-up capital and technology to the investee entity. Being experienced and sophisticated investors, they may even participate in the management and guide the entity to achieve its potential. This makes them somewhat akin to FDI. However, a distinct feature of FVCIs is that, they like to benefit from the listing gains and quit with the public issue of the company. Thus, they have features similar to portfolio investors also. It may be fair to term them as medium term investors as compared to portfolio investors, who could be considered short-term investors, and FDI investors, who are considered long-term investors.

There is a need to encourage investors who are willing to take risks and invest in not well known unlisted companies and guide them to become world class organisations. FVCIs have the potential to carry out this task.

[14] Report of Working Group on Foreign Investment in India, 2010
[15] Report of Working Group on Foreign Investment in India, 2010
[16] Report of the Committee on Fuller Capital Account Convertibility, 2006
[17] Report of the Financial Sector Legislative Reforms Commission, 2013

Consequently, CUTS recommends that non-FDI investment may be rationalised into two modes, viz., QFI/portfolio mode (which will consist of FII, NRI and extant QFI mode) and FVCI mode. However, this is easier said than done. FIIs, NRIs and QFIs, all are subject to different investment limits, are granted different exemptions, and in certain cases, may be subject to different tax regimes. Any careless merging of these modes may lead to crowding effect in the limited door size of portfolio investment. Thus, a calibrated approach is required that assists in achieving the desired framework within a definite time period in future.

4. Managing transition

Any change in regulatory approach requires management of intermediate transformation period until achievement of compliance by market participants to the new rules.

Considering comments of the Finance Minister in the budget speech, adoption of numerical guideline for distinguishing FDI and PI could be assumed. The current regulations do not prescribe any minimum investment criteria for FDI, thus, many FDI investors might have invested for less than the presumably applicable minimum threshold (10 percent). Consequently, post adoption of the numerical guideline, specific time period would need to be given to the non-compliant entities to comply with the revised norms.

FDI investors having invested below the specific limits could be asked to comply with portfolio investment norms or increase their investment beyond the threshold within specific time period. Adequate support could be given to such entities (in form of temporary relaxation from capital raising norms/ other restrictions) to enable compliance with the revised norms.

Further, clarity must be provided and overlap must be avoided in the investment limits currently prescribed for FDI and non-FDI transactions. It must also be clearly specified if the limits are to be aggregated or considered inclusive for calculation of total investment by a foreign investor.

In addition, it must be realised that substantial overlap in current regulatory regime will come in the way of rationalising the proposed portfolio/QFI mode of foreign investment. For instance, although registered FIIs and FVCIs are not allowed to invest through QFI route, NRIs are allowed to do so. Consequently, any merging of QFI and NRI route would limit the scope of NRI investment.

Similarly, at present, all proposed QFI/ portfolio route investors have distinct aggregate investment limits,[18] rationalising which into a single unified framework might create crowding out issues. To deal with this, CUTS recommends doing away with the aggregate investment limit for non-FDI investors. The rationale being that aggregate investment limit puts two potentially

[18] All FIIs taken together can invest up to 24 percent in the paid up share capital of a company. This limit can be increased up to sectoral cap/statutory limit applicable to the company, subject to compliance with certain conditions. Similarly, the aggregate investment limit of NRIs in the paid up share capital of a company is 10 percent, which can be hiked up to 24 percent, subject to compliance with certain conditions. The individual and aggregate investment limits for investment by QFIs in equity shares of listed companies is 5 percent and 10 percent respectively of the paid up capital of a company. These QFI limits are over and above the FII and NRI investment ceilings.

unrelated investors in a single basket. It must be possible for 10 different unrelated investors to hold 10 percent each in paid up share capital of a company. While there is obviously a possibility of a single investor investing through separate vehicles, such practices need to be checked through strong KYC requirements and an overall cap is not advisable, but seem to be just an easy way out for regulation.

In addition, currently, the proposed QFI/ portfolio investors have been granted different relaxations and could be potentially treated differently for taxation purposes. It has been pointed out by various committees in the past that some of these dissimilarities, being harder to monitor, involve complex structuring, which increases costs, thus dis-incentivising investments. Consequently, there is a need to carefully study each of such exemptions and deal with them (retain or discard) on merits.

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