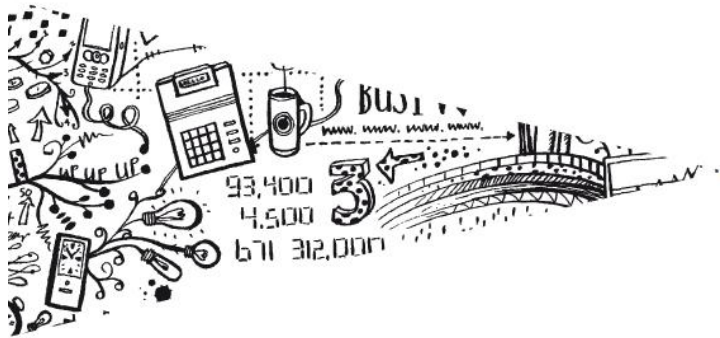


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EY Regulatory Alert

Investment by Foreign Investors in Mutual Fund Schemes



Background

The Finance Minister of India while presenting the Union Budget 2011 announced the intention of allowing Mutual Funds (MF), registered with the Securities and Exchange Board of India (SEBI, India's capital markets regulator) to accept subscriptions for equity schemes from foreign investors, who meet the 'Know Your Customer' (KYC) requirements.

In order to facilitate the same, SEBI in consultation with the Government of India and the Reserve Bank of India (RBI) issued a circular¹ on 9 August 2011 prescribing guidelines on investment by foreign investors (termed as Qualified Foreign Investors - QFIs) in equity and debt schemes of MF.

The investment by QFIs in equity and debt MF schemes shall also be subject to the regulations framed under the Foreign Exchange Management Act, 1999 and guidelines issued by the RBI from time to time. The RBI has also issued a circular specifying the terms and conditions for such investment.

We have discussed in this alert the salient provisions of the circulars issued.

Salient provisions

1. Meaning of QFI

QFI has been defined to mean a person who is resident in a country, other than India, that is compliant with Financial Action Task Force (FATF) standards and that is a signatory to International Organization of Securities Commission's Multilateral Memorandum of Understanding (MMU)².

SEBI registered Foreign Institutional Investor or sub-account (FII) shall not qualify as a QFI.

2. Investment routes

QFIs who meet the KYC requirement may invest in equity and debt schemes of MF through the following two routes:

- **Direct route** - Holding MF units in a securities account through a SEBI registered depository participant (DP)
- **Indirect route** - Holding MF units via Unit Confirmation Receipt (UCR)

3. Investment limits

Investments by QFIs through the aforesaid routes shall be subject to the following limits:

- The aggregate investments by QFIs under both routes shall be subject to an overall ceiling of USD 10 billion for equity schemes.
- The aggregate investments by QFIs under both routes for debt schemes which invest in infrastructure³ debt of minimum residual maturity of 5 years, shall be subject to a total overall ceiling of USD 3 billion.
- MF can accept subscriptions from QFIs till such time the investments by QFIs reaches USD 8 billion in equity schemes and USD 2.5 billion in debt schemes. The remaining limit of USD 2 billion and USD 0.5 billion in equity schemes and in debt schemes, respectively shall be auctioned by SEBI through bidding process.

² The terms 'person' and 'resident in India' shall have the meanings assigned under the Indian Income-tax Act, 1961. 'Resident in country' other than India, shall mean resident as per the direct tax laws of that country.

³ As defined under the extant External Commercial Borrowings guidelines issued by RBI

¹ Circular No.: CIR/IMD/DF/14/2011

4. Key responsibilities of MF/ DP

- MF shall ensure that QFIs meet the KYC requirements as per the FATF standards, Prevention of Money Laundering Act, 2002 and applicable SEBI circulars.
- MF/ DP shall require QFIs to submit necessary information for the purpose of obtaining a Permanent Account Number (PAN)⁴ and such additional information as may be required.
- MF/ DP shall also ensure that the designated overseas bank account of QFIs is based in countries which are compliant with FATF standards and are signatories to MMU. All subscriptions and redemptions shall be from/ to the same overseas bank account.
- MF/ DP shall ensure that the units held by QFIs under both routes are non transferable and non tradable.
- QFIs can only subscribe or redeem units of MF. Systematic investments/ transfer/ withdrawals and switches will not be available to QFIs.
- MF/ DP shall ensure that units/ UCRs held by QFIs are free from all encumbrances i.e. pledge or lien cannot be created for the units.

- MF shall ensure compliance with the laws of the jurisdictions where the QFIs are based.
- The subscription and redemption of units by the MF should be based on the Net Asset Value as per the applicable cut-off time which shall be disclosed in the scheme information documents.
- MF shall be responsible for the deduction of applicable tax at source out of the redemption proceeds before making redemption payments to QFIs.
- MFs shall file with SEBI a report on a daily basis detailing the total subscription and redemption by QFIs.

5. Additional conditions for investment through the direct route

- There are 3 parties under this route - QFIs, DP and MF.
- QFIs can open only one securities account with a qualified, SEBI registered DP⁵ and shall subscribe and redeem through that DP only.

- The DP shall open a separate single Indian Rupee pool bank account with a designated bank exclusively for the purpose of investments by QFIs in India.
- QFIs shall place a subscription order for a specific MF scheme, with the DP and remit freely convertible foreign currency through normal banking channels to the Indian Rupee pool bank account of the DP. The DP shall forward the order to the MF and remit the money to the MF scheme account. MF shall process the order and credit units into the QFIs' securities account.
- QFIs could redeem units by issuing instructions to the DP, which shall forward the same to the MF. Upon receipt of the instructions to redeem, the MF shall credit the Indian Rupee pool bank account of the DP with the redemption proceeds.
- Additional purchase of units of MF schemes is permitted to be made out of redemption proceeds, provided payment towards purchase is made within two working days of receipt of money from MF in the Indian Rupee pool bank account.

6. Additional conditions for investment through the indirect route

- There are 4 parties under this route - QFIs, MF, overseas UCR issuer and SEBI registered custodian (both appointed by MF).

⁵ A SEBI registered DP is required to fulfill certain criteria to act as a qualified DP, including, obtain prior approval of SEBI before commencing the activities relating to accepting MF subscription from QFIs, having minimum paid up capital of Rs 500 million, being either a clearing bank or clearing member of any of the clearing corporations, etc.

⁴ PAN is an alphanumeric tax identification number issued by the Indian Revenue authorities. A combined PAN-cum-KYC form is proposed to be issued for QFIs.

- QFIs can subscribe/ redeem only through the UCR Issuer.
- MF shall seek SEBI approval for appointing the UCR issuer to act as agent of the MF.
- The rupee denominated units of the MF would be held as underlying by the custodian in India in demat mode against which the UCR issuer would issue UCR to be held by QFIs.
- MF shall ensure that for every UCR issued by the UCR issuer, the custodian in India shall hold corresponding number of units against it i.e., there shall be one unit of MF scheme for every unit of UCR.
- UCR issuer to comply with requirements for KYC, customer due diligence process and documents and information to be collected from the QFIs, under mandate of MF.
- Units purchased and redeemed through the UCR issuer shall be settled on a gross basis and shall not be netted against other investors of the UCR issuer.
- MF shall receive money from UCR issuer either in foreign country by opening bank account overseas or in Indian rupees in the respective MF scheme account held in India.
- Where MF opens overseas bank account, redemption and dividend payouts would be routed through this account for onward

payment to designated overseas bank account of QFIs.

- In case MF receives money in India from the UCR issuer, remittance and dividend payouts would be made to the UCR issuer which in turn would remit the proceeds to the designated overseas bank account of QFIs.

Comments

The introduction of guidelines by SEBI, governing investment by QFIs in Indian MF, is in line with the Government's intention to provide direct access to foreign investors to MF, thereby opening another avenue for capital market inflows.

The success of this avenue would be driven largely by the ability of MF to distinguish their schemes from similar offshore products available for subscription to foreign investors. Onerous conditions for compliance with the regulatory framework prevailing in foreign countries may restrict the ability of MF to distribute schemes in certain jurisdictions. Further, the need to obtain a PAN in India and the consequent need to file a tax return in India may act as a deterrent to foreign investor participation.

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