

THE DYNAMIC INDIAN FOREIGN INVESTMENT REGULATORY REGIME

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Indian economy

India has grown to become a trillion dollar economy characterised by liberalised foreign investment and trade policy. Of the growth, the dominant role is played by the private sector which is spurred by deregulation. The country's GDP is growing at an average rate of 8.5% every year and is counted as one of the best amongst the emerging economies. Notwithstanding the global slowdown and turbulent financial conditions, the Indian economy smoothly sailed through the testing times, thanks to a strong and vibrant financial and banking sector in India. A lot of credit goes to the efficient regulatory supervision and measures undertaken by the Reserve Bank of India (RBI), the Indian central bank cum banking regulator and the Securities and Exchange Board of India (SEBI), the Indian securities market regulator. As per the recent Global Competitiveness Report 2010-2011 published by the World Economic Forum, India ranks 17 (out of 139 countries) in the vital field of "Financial Market Development".

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Overview of the regulatory framework

From 1991, trade liberalisation in India has been accompanied by a process of gradual liberalisation of capital flows management regulations. Foreign Direct Investment (FDI) by non-resident in resident entities through transfer or issue of securities to persons resident outside India is a 'capital account transaction' and Government of India and RBI regulate the same under the Foreign Exchange Management Act, 1999 (FEMA) and various regulations framed under the Act. RBI is given primary authority to regulate capital flows through FEMA. Notably, Section 6 of FEMA authorises the RBI to manage foreign exchange transactions and capital flows in consultation with the Ministry of Finance. SEBI (Foreign Institutional Investors) Regulations, 1995 (FII Regulations) have facilitated the regulation of portfolio investments and strengthened India's opening to world markets. Supplementing RBI and SEBI, the other institutional bodies regulating capital flows include the Forward Markets Commission (FMC), the Insurance Regulatory and Development Authority (IRDA) and the Pension Fund Regulatory and Development Authority (PFRDA). The two routes for foreign investments - the foreign direct investment route and foreign portfolio investment route are the key constituents of this concept paper.

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Foreign Direct Investments (FDI) ... (1/3)

India continues to remain one of the most attractive destination for FDI in the world thanks to a liberal FDI policy, recently modified, consolidated and notified on September 29, 2010 under the Circular 2 of 2010. According to the World Investment Prospects Survey 2010–2012¹, India will be the second-most popular destination for FDI globally over the next two years². This is an improvement over the projection made in World Investment Prospects Survey 2009–2011, which ranked India third in the list. Cumulative amount of FDI equity inflows from August 1991 to November 2010 in India stood at US\$ 140,920 million, as per the data released by Department of Industrial Policy and Promotion (DIPP) of the Ministry of Commerce and Industry. FDI is permitted in most of the sectors under the automatic route with only post investment notifications, except a few areas where approval from the government is required. Several key sectors like telecom, insurance, construction, information technology, broadcasting, financial services, civil aviation and even defence are open to FDI investments. Foreign Investment Promotion Board (FIPB) is a nodal agency which approves foreign investment proposals falling under the approval route.

- **Recent regulatory changes facilitating foreign direct investments:** The Indian FDI policy has seen some rapid changes, especially in the past 18 months. The beginning of year 2009 witnessed issue of Press Notes 2, 3 and 4 pertaining to notification of the new methodology to calculate direct and indirect foreign investments in Indian companies and in turn simplifying the FDI regime³. The circulars provided for a very rational and reasoned approach to define what “owned” and “controlled” would mean while calculating the foreign ownership in Indian companies from an FDI perspective.

¹ A publication by United Nations Conference on Trade and Development's (UNCTAD)

² http://www.unctad.org/en/docs/diaeia20104_en.pdf

³ Press Note 2 of 2009 and Press Note 3 of 2009 were issued on February 13, 2009. Press Note 4 of 2009 was issued on February 15, 2009. The Press Notes are available on the DIPP website <http://www.dipp.nic.in/>

Foreign Direct Investments (FDI) ... (2/3)

The Finance Minister's budget speech of 2010-11 stressed on making the FDI policy user-friendly by consolidating all prior regulations and guidelines into one comprehensive document. As a result, Circular 1 of 2010 was issued on March 31, 2010 which consolidated all the prior policies/regulations, press notes, press releases, clarifications etc. pertaining to FDI. The Government is committed to bring out an updated FDI policy every six months consolidating the entire regime for FDI at one place for easy reference. Pursuant to this the recent Circular 2 of 2010 issued by DIPP provides an updated and consolidated FDI policy effective from October 1, 2010.

In the recent Circulars 1 and 2 of 2010, a number of positive changes have been brought in viz. (i) It is now clarified that the issue of partly paid shares and warrants to persons resident outside India is permissible with prior Government approval, (ii) 100% FDI under automatic route has been permitted for undertaking certain agriculture activities and animal husbandry, (iii) For sectors not mentioned under sector specific policy for FDI, it has been stated that 100% FDI under automatic route will be allowed, subject to applicable laws, (iv) Earlier all foreign investments above the limit of INR 600 crores (INR 6 billion) required approval of the Cabinet Committee of Economic Affairs (CCEA), which has now been raised to INR 1200 crores (INR 12 billion) in order to further reduce the approval processes.

Foreign Direct Investments (FDI) ... (3/3)

- **Figures that count:** As per data sourced from DIPP, the cumulative amount of FDI equity inflows from August 1991 to November 2010 stood at US\$ 140.9 billion. India received FDI inflows of US\$ 393 million⁴ in the financial year 1992-93 which have substantially increased to US\$ 25.8 billion in the financial year 2009-10. During the financial year 2010-11 (April-November), FDI equity inflow of US\$ 14 billion has already been attracted by India. As on November 2010, the service sector (financial and non-financial) has been the prominent sector staying at the top in terms of FDI inflows standing at 21.07% of the total inflows since the year 2000. Computer software and hardware follows the list with 8.40% share closely followed by telecommunication and housing & real estate at 8.06% and 7.53% respectively. This clearly reflects that the key sectors viz. the service sector, IT, telecommunication and infrastructure which provide attractive profit margins to foreign investors, have attracted greater FDI inflows and the foreign investors have a great opportunity to further participate in India's growing economy by investing in these key sectors along with the other strategic areas like defence, insurance, retail etc.

Opening up and widening of several important sectors like infrastructure, townships, housing, cash and carry trading, wholesale trading, E-Commerce, single brand retail, commodity exchanges etc. have further spurred the interest in India as the FDI capital of world. More interest is being shown in retail sector which India is gradually opening up. Plans to introduce FDI in multi brand retail seem to be on the horizon.

As a result of opening up of several key sectors, substantial investments have been received and this in turn has assisted in re-iterating the India growth story even during the financial turmoil. The key sectors in India have been adequately capitalised and insulated from external jitters of the likes of global slowdown of 2008-09.

⁴ http://www.dipp.nic.in/fdi_statistics/India_yearwise.pdf

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Foreign Institutional Investments ... (1/2)

Foreign institutional investors (FIIs) and Sub-Accounts of FIIs can make portfolio investment in India by obtaining a simple registration with SEBI to invest in listed Indian securities and primary offerings. There are no restrictions on repatriation of dividends or sale proceeds or any minimum holding time frame. India is considered to be one of the best destinations for foreign portfolio investments with foreign investors generating substantial returns. India has cumulative FII investments of US \$100.9 billion as on November 2010, as per the data provided by SEBI.

- **Changes facilitating foreign portfolio investments:** FII Regulations were substantially amended in May 2008 (2008 Amendments) attracting and facilitating more foreign investors to register with SEBI as FIIs or their Sub-Accounts and has enabled participation in the growing Indian economy. In the 2008 Amendments a number of positive changes were brought in viz. (i) the definition of “broad based fund” under FII Regulations was substantially widened allowing several more Sub-Accounts and FIIs to register with SEBI, (ii) Several new categories of registration viz. sovereign wealth funds, foreign individual, foreign corporate etc. were introduced, (iii) Registration once granted to foreign investors was made permanent without a need to apply for renewal from time to time thereby substantially reducing the administrative burden. Also, the application fee for foreign investors applying for registration has recently been reduced by 50% for FIIs/Sub-Accounts and the application forms were simplified making registration process simple and fast. These measures have resulted in increased direct registrations and greater inflows.

Foreign Institutional Investments ... (2/2)

The number of FII registrations with SEBI has substantially increased post the 2008 Amendments and as on November 2010 there are 1738 FIIs and 5592 Sub-Accounts registered with SEBI. The number has increased substantially in the past two years in view of the Indian economy offering lucrative investment opportunities. The erstwhile rigid criteria of requiring FIIs and Sub-Accounts to register as a 70:30 FII/Sub-Account or 100% debt FII/Sub-Account has recently been done away with, further showing the commitment to simplify the registration and operational issues pertaining to foreign portfolio investors.

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Banking sector and role of RBI

The Indian banking sector has become market driven since 1991 witnessing entry of new private sector banks and a host of reforms introduced by RBI. The Banking Regulation Act, 1949, and the RBI Act, 1934 provide the RBI with supporting authority to regulate capital flows and are the major statutes governing banking sector in India. RBI allows a liberal FDI Policy for investing in Indian private sector banks upto 74% with permissible FII investments upto 49%. RBI has been taking gradual steps for Indian banks to be compliant with Basel III norms. Foreign investments in public or nationalised banks in India are subject to a limit of 20%.

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Capital markets and role of SEBI

Indian capital markets have witnessed a huge transformation in the past two decades and are considered to be one of the most attractive investment destinations among large emerging economies of the world. India has robust, transparent and stable financial markets regulated by SEBI. The SEBI regulatory regime provides an enabling framework for offshore investors to invest in Indian securities and participate in the India growth story. FII regulations and SEBI (Foreign Venture Capital Investor) Regulations, 2000 allow eligible foreign investors to invest in Indian listed and unlisted securities, mutual fund units etc. SEBI (Issue of Capital and Disclosure Requirements) Regulations, 2009 provide a robust framework for foreign investors, pension funds, foreign insurance companies, foreign mutual funds, sovereign wealth funds and several other eligible offshore investors to participate in initial offerings and private placements by Indian companies. Indian equity markets are one of the deepest and most liquid of any market in the world with volumes in the top five in the world and a market cap in excess of the GDP of the country. Foreign investors have been permitted to raise capital from Indian markets by issuing Indian Depository Receipts (IDRs). Standard Chartered Bank of UK recently raised US\$ 530 million by way of an IDR issue. Many foreign companies are taking interest in raising money through this route redefining the term 'capital exporting economies'.

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Other key areas

- **Strong Debt Markets:** A deep liquid debt market in India has been generating consistent and safe returns for offshore investors. Considering the interests of overseas investors, the Government has prescribed high investment limits of USD 20 billion for investments in corporate debt securities and USD 10 billion for investments in government debt securities.
- **Strong Deal destination:** India is becoming a hub of both in-bound and out-bound mega M&A deals, private equity transactions and a thriving Venture Capital Industry.
- **Robust Insurance Sector:** India has a strong insurance sector with liberal FDI policy permitting FDI of 26% with proposals to raise it upto 49% in the near term. Several private players offer affordable insurance covers and innovative products and the space is being regulated by IRDA, the key statutes being Insurance Act, 1938 and Insurance Regulatory and Development Authority Act, 1999.
- **DTAA:** India has entered into double tax avoidance agreements (DTAAs) with all the major jurisdictions in the world providing for liberal provisions to avoid any double taxation on incomes and capital gains and grants exemptions on earnings by foreign investors in India as per the respective treaty provisions. Key jurisdictions used by foreign investors include Mauritius and Singapore which have favourable treaties.

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Way forward

The Indian economy is possessed with a sound and stable financial and banking sector resulting in greater foreign participation as is evident in continuously rising FDI and FII investments. These trends are likely to continue given the liberal trade policies and efficient regulatory regime. India is in the process of introducing comprehensive and far reaching changes to its commercial and corporate regulatory framework. Such proposed changes include introduction of a new Companies Act, Direct Tax Code, fully adopting International Financial Reporting Standards (IFRS) and moving to more transparent models of governance. With a strong commitment to ensure effective compliance with Basel norms and the standards prescribed by International Organisation of Securities Commissions (IOSCO), India is following international best practices and standards. The cautious and at the same time liberal investment norms ensure that the country would continue to attract large foreign investments and continue to outpace other developing and developed economies.

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