

# “STUDY OF PORTFOLIO PREFERENCES OF FOREIGN INSTITUTIONAL INVESTORS”

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## ABSTRACT

*The present paper describes on brief the legitimate framework pertaining to foreign institutional investors in India. The various aspects covered herein are registration procedure, condition for grant or renewal of certificate to foreign institutional investors, procedure when certificate is not granted, registration of sub-accounts, restricted and condition on investment by foreign institutional investors, code of conduct for the foreign institutional investors and procedure for action in case of default.*

*This study is descriptive and experimental in nature as the effect of certain events or actions have been observed in it objectively and by distinguishing the effect of extraneous variables.*

Recent research has also shown that rising institutional ownership has contributed to both increased trading liquidity and corporate governance reforms in Indian companies. However, our understanding of investment in emerging markets by Indian institutional investors is quite limited. The objective of this paper is to provide a better understanding of the preferences of foreign institutional investors as revealed by their portfolio holdings in emerging market equities. We analyze portfolio holdings of FIIs with respect to countries, equity markets, and firms that they invest in.

### Registration Process

FIIs must be mandatorily registered with SEBI to buy, sell or otherwise deal in securities. After the registration a FII gets a registration certificate. The registration process of a FII is shown in Figure 4.1. This process is described in brief as follows:

### Application for Registration

An application for the grant of certificate shall be made to SEBI in Form A (Annexure 1). Any Foreign Institutional Investor who has made an application for the grant of a certificate to the Board prior to the commencement of these regulations shall be deemed to have made an application and the application shall be accordingly dealt with under these regulations.

### Furnishing of Information, Explanation, and Personal Representation

The Board may require the applicant to furnish such further information or clarification as the Board considers necessary regarding matters relevant to the activities of the applicant for grant of certificate.

The applicant or his authorized representative shall, if so required by the Board, appear before the Board for personal representation in connection with the grant of a certificate.

### **Application to Conform to the Requirements**

Subject to the provisions, the Board shall reject any application, which is not complete in all respects and does not conform to the instructions specified in the form or is false or misleading in any particular material. Provided that, before rejecting any such application, the applicant shall be given a reasonable opportunity to remove it, within the time specified by the Board.

### **Consideration of Application**

For the purpose of the grant of certificate the Board shall take into account all matters which are relevant to the grant of a certificate and in particular the following: -

- 1) The applicant's track record, professional competence, financial soundness, experience, general reputation of fairness and integrity.
- 2) Whether an appropriate foreign regulatory authority regulates the applicant.
- 3) Whether the applicant has been granted permission under the provisions of the Foreign Exchange Regulation Act, 1973 (46 of 1973) by the Reserve Bank of India for making investments in India as a Foreign Institutional Investor.
- 4) Whether the applicant is: -
  - (i) An institution established or incorporated outside India as Pension Fund or Mutual Fund or Investment Trust
  - (ii) An Asset Management Company or Nominee Company or Bank or Institutional Portfolio Manager, established or incorporated outside India and proposing to make investments in India on behalf of broad based funds and its proprietary funds, if any.
  - (iii) A Trustee or a Power of Attorney holder incorporated or established outside India, and proposing to make investments in India on behalf of broad based funds.
  - (iv) University fund, endowments, foundations or charitable trusts or charitable societies.
- 5) While considering the applications the Board may take into account the following:
  - (i) Whether the applicant has been in existence for a period of at least 5 years.
  - (ii) Whether the applicant is legally permissible to invest in securities outside the country of its incorporation or establishment.
  - (iii) Whether the applicant has been registered with any statutory authority in the country of their incorporation or establishment.
  - (iv) Whether any statutory authority has initiated any legal proceeding against the applicant.
- 6) Whether the grant of certificate to the applicant is in the interest of the development of the securities market.

Whether the applicant is a fit and proper person. A domestic portfolio manager or domestic asset management company shall be eligible to be registered as a foreign institutional investor to manage the funds of sub-accounts. It shall make an application. For the grant of certificate to a domestic asset management company or to a domestic portfolio manager the Board shall consider the following:

- (i) Whether the applicant is an approved asset management company or a registered portfolio manager and that the approval or registration is valid

(ii) Whether any disciplinary proceeding is pending before the Board against such applicant.

### **Grant of Certificate**

Where an application is made for grant of certificate under these regulations, the Board shall, as soon as possible but not later than three months after information called for by it is furnished, if satisfied that the application is complete in all respects, all particulars sought have been furnished and the applicant is found to be eligible for the grant of certificate, grant a certificate subject to payment of fees. Every applicant eligible for grant of a certificate shall pay a registration fee of US\$ 5,000. The registration fee shall be payable by the applicant by a draft in favor of "Securities and Exchange Board of India" or by any appropriate mode or instrument as may be specified by the Board. Provided that the Board may exempt from the payment of fees, an applicant such as the World Bank and other institutions established outside India for providing aid, and which have been granted privileges and immunities from the payment of tax and duties by the Central Government. Provided further that a domestic portfolio manager or domestic asset management company shall not be liable to pay fee.

### **Validity of Certificate**

The certificate and each renewal thereof shall be valid for a period of five years from the date of its grant or renewal, as the case may be. Provided further that the certificate of registration granted or approved under the Securities and Exchange Board of India (Portfolio Managers) Regulations, 1993 or the securities and Exchange Board of India (Mutual Funds) Regulations, 1996, expires before the expiry of registration under these Regulations, or the certificate of such entity is suspended, the domestic portfolio manager or domestic asset management company shall cease to carry on any activity as foreign institutional investor and shall be subject to the directions of the Board with regard to the fund, securities or records that may be in its custody or control as a foreign institutional investor.

### **Application for Renewal of Certificate**

Three months before the expiry of the period of certificate, the Foreign Institutional Investor, if he so desires, may make an application for renewal. Provided that a Foreign Institutional Investor who does not desire to renew its registration or has failed to make an application for renewal shall, at the time of expiry of registration, obtain a specific permission from the Board, for disinvesting the securities held by it on its own account or on behalf of its sub-account(s), within a stipulated time period, subject to such terms and conditions as may be specified by the Board. The application for renewal shall, as far as possible, may be dealt with in the same manner as if it were an application made for grant of a certificate. The Board, on such application, if satisfied that the applicant fulfils the requirements, shall grant a certificate subject to payment of fees.

### **Circumstances for Grant or Renewal of Certificate to Foreign Institutional Investors**

The grant or renewal of certificate to the Foreign Institutional Investor shall be subject to the following conditions, namely:

- He shall abide by the provisions of these regulations;
- If any information or particulars previously submitted to the Board are found to be false or misleading, in any material respect, he shall forthwith inform the Board in writing;
- If there is any material change in the information previously furnished by him to the Board, which has a bearing on the certificate granted by the Board, he shall forthwith inform the Board;
- He shall appoint a domestic custodian and before making any investments in India, enter into an agreement with the domestic custodian providing for custodial services in respect of securities;
- He shall, before making any investments in India, enter into an arrangement with a designated bank for the purpose of operating a special non-resident rupee or foreign currency account; and
- Before making any investments in India on behalf of a sub-account, if any, he shall obtain registration of such sub-account, under these regulations.

#### **Process Where Certificate is not Granted**

Where an application for grant or renewal of a certificate does not satisfy the requirements, the Board may reject the application after giving the applicant a reasonable opportunity of being heard. The decision to reject the application shall be communicated by the Board to the applicant in writing stating therein the grounds on which the application has been rejected. The applicant, who is aggrieved by the decision of the Board may, within a period of thirty days from the date of receipt of communication apply to the Board for reconsideration of its decision. The Board shall, as soon as possible, in the light of the submissions made in the application for reconsideration made and after giving a reasonable opportunity of being heard, convey its decision in writing to the applicant.

#### **Application for Registration of Sub-Accounts**

A Foreign Institutional Investor shall seek from the Board registration of each sub-account on whose behalf he proposes to make investments in India. A sub Account of a FII should be an institution or fund or portfolio established or incorporated outside India. This fund or portfolio is required to be "broad based". Foreign corporate and foreign individuals can also be registered as Sub Accounts; they need not be "broad based". The FII through whom an application is made for Sub Account registration should be authorized to manage investments on behalf of the Sub Account. In other words sub-account includes foreign corporates or foreign individuals and those institutions, established or incorporated outside India and those funds, or portfolios, established outside India, whether incorporated or not, on whose behalf investments are proposed to be made in India by a Foreign Institutional Investor.

A broad based fund is a fund, which has more than 20 shareholders, and no single investor holds more than 10% of the fund. In case, if any investor holds more than 10% of the fund, it in turn should be broad based.

### **Registration of Sub-Accounts**

For the purpose of registration, the Board shall take into account all matters which are relevant to the grant of such registration to the sub-account and in particular the following:

- The applicant is an institution or fund or portfolio established or incorporated outside India and proposes to make investment in India.
- The applicant is a broad based fund or proprietary fund or a foreign corporate or individual. The applicant is a fit and proper person. Provided that a non-resident Indian or an overseas corporate body registered with Reserve Bank of India shall not be eligible to invest as sub-account or as foreign institutional investor.
- The Foreign Institutional Investor through whom the application for registration is made to the Board holds a certificate of registration as Foreign Institutional Investor.
- The Foreign Institutional Investor, through whom an application for registration of sub-account is made, is authorized to invest on behalf of that sub-account.
- The Foreign Institutional Investor through whom the application for registration is made has submitted undertakings that the sub-account fulfils the criteria referred to in this sub-regulation. In case the sub-account is a foreign corporate or individual, the foreign institutional investor, through whom the application for registration is made, shall furnish information and undertaking.
- The sub-account has paid registration fees.
- The Board on receipt of the undertakings and the registration fees may grant registration to the sub-account. A sub-account granted registration in accordance with this regulation shall be deemed to be registered as a Foreign Institutional Investor with the Securities and Exchange Board of India for the limited purpose of availing of the benefits available to Foreign Institutional Investors under section 115 AD of Income Tax Act, 1961, (43 of 1961).

### **General Obligation and Responsibilities**

FII's have to face some other general obligations and responsibilities, which are as follows:

#### **1) Appointment of Domestic Custodian**

A Foreign Institutional Investor or a global custodian acting on behalf of the Foreign Institutional Investor shall enter into an agreement with a domestic custodian to act as custodian of securities for the Foreign Institutional Investor. The domestic custodian includes any person carrying on the activity of providing custodial services with respect to securities. The FII can appoint more than one domestic custodian with the SEBI's prior permissions but only one for a single sub-account. The Foreign Institutional Investor shall ensure that the domestic custodian takes steps for:

- Monitoring of investments of the Foreign Institutional Investor in India.
- Reporting to the Board on a daily basis the transactions entered into by the Foreign Institutional Investor.
- Preservation for five years of records relating to his activities as a Foreign Institutional Investor.
- Furnishing such information to the Board as may be called for by the Board with regard to the activities of the Foreign Institutional Investor and as may be relevant for the purpose of this regulation.

## 2) **Appointment of Designated Bank**

A Foreign Institutional Investor shall appoint a branch of a bank approved by the Reserve Bank of India for opening of foreign currency denominated accounts and special non-resident rupee accounts.

## 3) **Investment Advice in Publically Accessible Media**

A Foreign Institutional Investor or any of his employees shall not render directly or indirectly any investment advice about any security in the publically accessible media, whether real-time or non real-time, unless a disclosure of his interest including long or short position in the said security has been made, while rendering such advice. In case, an employee of the Foreign Institutional Investor is rendering such advice, he shall also disclose the interest of his dependent family members and the employer including their long or short position in the said security, while rendering such advice.

## 4) **Maintenance of Proper Books of Accounts, Record**

Every Foreign Institutional Investor shall keep or maintain, as the case may be, the following books of accounts, records and documents:

- True and fair accounts relating to remittance of initial corpus for buying, selling and realizing capital gains of investment made from the corpus;
- Accounts of remittances to India for investments in India and realizing capital gains on investments made from such remittances;
- Bank statement of accounts;
- Contract notes relating to purchase and sale of securities and Communication from and to the domestic custodian regarding investments in securities.

The Foreign Institutional Investor shall intimate to the Board in writing the place where such books, records and documents will be kept or maintained.

## 5) **Preservation of Books of Accounts, Records**

Subject to the provisions of any other law, for the time being in force, every Foreign Institutional Investor shall preserve the books of accounts, records and documents for a minimum period of five years.

**6) Appointment of Compliance Officer**

Every Foreign Institutional Investor shall appoint a compliance officer who shall be responsible for monitoring the compliance of the Act, rules and regulations, notifications, guidelines, instructions etc issued by the Board or the Central Government. The compliance officer shall immediately and independently report to the Board any non-compliance observed by him.

**7) Information to the Board**

Every Foreign Institutional Investor shall, as and when required by the Board or the Reserve Bank of India, submit to the Board or the Reserve Bank of India, as the case may be, any information, record or documents in relation to his activities as a Foreign Institutional Investor as the Board or as the Reserve Bank of India may require. Foreign Institutional Investors shall fully disclose information concerning the terms of and parties to off-shore derivative instruments such as Participatory Notes, Equity Linked Notes or any other such instruments, by whatever names they are called, entered into by it or its sub-accounts or affiliates relating to any securities listed or proposed to be listed in any stock exchange in India, as and when and in such form as the Board may require.

**Code of Demeanor for Foreign Institutional Investors**

1. A Foreign Institutional Investor and its key personnel shall observe high standards of integrity, fairness and professionalism in all dealings in the Indian securities market with intermediaries, regulatory and other government authorities.
2. A Foreign Institutional Investor shall, at all times, render high standards of service, exercise due diligence and independent professional judgment.
3. A Foreign Institutional Investor shall ensure and maintain confidentiality in respect of trades done on its own behalf and/or on behalf of its sub-accounts/clients.
4. A Foreign Institutional Investor shall ensure the following: a) clear segregation of its own money/securities and sub-accounts' money/securities. b) Arms length relationship between its business of fund management/ investment and its other business.
5. A Foreign Institutional Investor shall maintain an appropriate level of knowledge and competency and abide by the provisions of the Act, regulations made there under and the circulars and guidelines, which may be applicable and relevant to the activities carried on by it. Every Foreign Institutional Investor shall also comply with award of the Ombudsman and decision of the Board under Securities and Exchange Board of India (Ombudsman) Regulations, 2003.
6. A Foreign Institutional Investor shall not make any untrue statement or suppress any material fact in any documents, reports or information furnished to the Board.

7. A Foreign Institutional Investor shall ensure that good corporate policies and corporate governance are observed by it.
8. A Foreign Institutional Investor shall ensure that it does not engage in fraudulent and manipulative transactions in the securities listed in any stock exchange in India.
9. A Foreign Institutional Investor or any of its directors or manager shall not, either through its/his own account or through any associate or family members, relatives or friends indulge in any insider trading.
10. A Foreign Institutional Investor shall not be a party to or instrumental for:  
a) Creation of false market in securities listed or proposed to be listed in any stock exchange in India.  
b) Price rigging or manipulation of prices of securities listed or proposed to be listed in any stock exchange in India  
c) Passing of price sensitive information to any person or intermediary in the securities market

#### **Process for Action in Case of Default**

A Foreign Institutional Investor who fails to comply with any condition subject to which certificate has been granted or contravenes any of the provisions of the Act or these regulations, shall be liable to the penalty of:

- Suspension of certificate for a specified period or
- Cancellation of certificate, after an enquiry as provided for in these regulations has been held.

#### **Deferral of Certificate**

A penalty of deferral of certificate of a Foreign Institutional Investor may be imposed if:

- (i) He indulges in fraudulent transactions in securities.
- (ii) He fails to furnish any information related to his transaction in securities as required by the Board or the Reserve Bank of India.
- (iii) He furnishes false information to the Board.
- (iv) He does not co-operate in any enquiry conducted by the Board.

#### **Annulment of Certificate**

A penalty of annulment of certificate of a Foreign Institutional Investor may be imposed if:

- (i) He indulges in deliberate manipulation or price rigging or cornering activities prejudicially affecting the securities market or the investors' interest

- (ii) He is guilty of fraud or a criminal offence, involving moral turpitude. In this regulation, "fraud" shall have the same meaning as is assigned to it in section 17 of the Indian Contract Act, 1872.
- (iii) He does not meet the eligibility criteria laid down in these regulations.
- (iv) He violates the provisions of the Securities and Exchange Board of India (Insider Trading) Regulations, 1992 or of the Securities and Exchange Board of India (Prohibition of Fraudulent and Unfair Trade Practices Relating to Securities Markets) Regulations, 1995, made under the Act.
- (v) He is guilty of repeated defaults.

### **Mode of making order of deferral and annulment of certificate**

No order of penalty of deferral or annulment of certificate shall be imposed on the Foreign Institutional Investor except after holding an enquiry. The enquiry can be conducted in following manner.

- For the purpose of holding the enquiry the Board may appoint an enquiry officer.
- The enquiry officer shall issue to the Foreign Institutional Investor a notice at the principal place of business of the Foreign Institutional Investor setting out the default alleged to have been committed by the Foreign Institutional Investor and calling upon him to show because why the penalties should not be imposed on him.
- The Foreign Institutional Investor may, within thirty days from the date of receipt of such notice, furnish to the enquiry officer a reply, together with copies of documentary or other evidence relied on by him in support of its reply: Provided that the enquiry officer may call upon him to supply further information.
- The enquiry officer shall, give a reasonable opportunity of hearing to the Foreign Institutional Investor to enable him to make submission in support of his reply.
- Before the enquiry officer, the Foreign Institutional Investor may either appear in person or through any person duly authorized by him in writing.
- If it is considered necessary, the enquiry officer may ask the Board to appoint a presenting officer to present its case.
- The enquiry officer shall, after taking into account all relevant facts and submissions made by the Foreign Institutional Investor and by the presenting officer, if appointed submit a report to the Board and recommend the penalty if any to be awarded along with the justification for such penalty.

### **Show Cause Notice and Order**

On receipt of the report from the enquiry officer, the Board shall consider the same and issue a show-cause notice to the Foreign Institutional Investor as to why the penalty, which it considers appropriate and which shall be specified in the notice should not be imposed. The Foreign Institutional Investor shall within twenty-one days of the date of the receipt of the show-cause notice send to the Board a reply to the notice.

The Board after considering the reply to the show-cause notice, if received in time, shall as soon as possible but not later than thirty days from the receipt of the reply, if any, pass such order as it deems fit. Every order passed shall be self-contained and give reasons for the conclusions stated therein including the justification for the penalty, if any, imposed by that order.

### **Consequence of deferral and annulment of Certificate**

On and from the date of the deferral of certificate, the Foreign Institutional Investor shall cease to buy, sell or otherwise deal in securities in India during the period of suspension.

On and from the date of cancellation of certificate, the Foreign Institutional Investor shall cease to buy, sell or otherwise deal in securities in India, except for the purpose of liquidating the existing investments.

### **Publication of Order of Suspension and Cancellation of Certificate**

The order of suspension or annulment of certificate shall be published by the Board in at least two daily newspapers.

### **Appeal to Securities Appellate Tribunal**

Any person aggrieved by an order of the Board made, on and after the commencement of the Securities Laws (Second Amendment) Act, 1999, (i.e., after 16th December 1999), under these regulations may prefer an appeal to a Securities Appellate Tribunal having jurisdiction in the matter.

### **References**

- Dept. of Economic Affairs (2005), Report of the Expert Group on Encouraging FII Flows and Checking the Vulnerability of Capital Market to Speculative Flows, Ministry of Finance, *Government of India*, New Delhi, November.