asifma

Growing Asia's Markets

Accessing India's Equity Markets

Reform, Perform and Transform

February 2018

Contributors:

cyril amarchand mangaldas
advocates & solicitors

EY

Juris Corp
advocates & solicitors

pwc

Disclaimer

The information and opinion commentary in this ASIFMA – Accessing India's Equity Markets Paper (Paper) was prepared by the Asia Securities Industry and Financial Markets Association (ASIFMA) to reflect the views of our members. ASIFMA believes that the information in the Paper, which has been obtained from multiple sources believed to be reliable, is reliable as of the date of publication. The data provided in the paper is the data available as of the date of publication, unless otherwise specified. As estimates by individual sources may differ from one another, estimates for similar types of data could vary within the Paper. In no event, however, does ASIFMA make any representation as to the accuracy or completeness of such information. ASIFMA has no obligation to update, modify or amend the information in this Paper or to otherwise notify readers if any information in the Paper becomes outdated or inaccurate. ASIFMA will make every effort to include updated information as it becomes available and in subsequent Papers.

ASIFMA is an independent, regional trade association with over 100 member firms comprising a diverse range of leading financial institutions from both the buy and sell side including banks, asset managers, law firms and market infrastructure service providers. Together, **we harness the shared interests of the financial industry to promote the development of liquid, deep and broad capital markets in Asia.** ASIFMA advocates stable, innovative and competitive Asian capital markets that are necessary to support the region's economic growth. We drive **consensus, advocate solutions and effect change around key issues through the collective strength and clarity of one industry voice.** Our many initiatives include consultations with regulators and exchanges, development of uniform industry standards, advocacy for enhanced markets through policy papers, and lowering the cost of doing business in the region. Through the GFMA alliance with SIFMA in the US and AFME in Europe, ASIFMA also provides insights on **global best practices and standards to benefit the region.**

TABLE OF CONTENTS

ASIFMA would like to extend its gratitude to Cyril Amarchand Mangaldas, EY, JurisCorp, and PwC, and all of the individuals and member firms who contributed to the development of this paper. Chapters drafted entirely by a specific firm are denoted with the firm logo.

A. Executive Summary

Ever since India started its economic reforms in the early nineties, there has been a metamorphosis in the Indian capital markets. Whilst India has historically been a challenging destination for foreign investors, the administration of current Prime Minister Modi has launched a raft of reforms to encourage investment driven by its commitment to improve India's ranking in the World Bank's 'ease of doing business' index. These structural reforms included tax and regulatory changes and the recent efforts to ease direct access for Foreign Portfolio Investors (FPIs) following restrictions on the Offshore Derivatives Instruments (ODI) markets.

India's economic performance continues to attract international investors. Despite a temporary slowdown to a 3-year low of 5.7% following the introduction of the Goods and Services Tax (GST) and demonetization in 2016, the International Monetary Fund (IMF) forecasts 7.4% growth for India in 2018. In fact, India looks set to leapfrog Britain and France next year to become the world's fifth-largest economy in dollar terms, according to the Centre for Economics and Business Research consultancy's 2018 World Economic League Table. It is one of the major G-20 economies with an average growth rate of around 7% over the last two decades and continues to be an important contributor to the pace of global growth.

India first lifted restrictions on foreign investors and allowed them to invest directly in listed companies in late 2011. This was followed by the introduction of FPI regulations that considerably eased the entry norms for FPIs to access India's capital markets. Nevertheless, due to the remaining frictions and certain tax and legal advantages, many foreign investors preferred to gain exposure to India through ODIs. With the Securities & Exchange Board (SEBI)'s increasingly stringent restrictions on ODIs, it is key for India to further smoothen the FPI registration and ongoing compliance process, as well as focus on reducing investment frictions in order to attract foreign investors into its capital markets, both debt and equity.

Equity markets are a vital part of the capital markets, delivering the share capital that every company needs at the core of its balance sheet. India needs healthy equity markets to provide Indian companies with long-term capital for growth, leading to higher levels of economic activity, greater wealth and more jobs. Equity capital is particularly important for funding companies in high-growth sectors such as technology, communications and energy. Despite some moves in the right direction, more can be done to ease access for foreign institutional investors in India's (equity) markets.

In this paper, we will outline the importance of capital markets (both debt and equity) and specifically capital markets supported by institutional investors due to their size and the stability they add to the market. We then look into capital markets in the Asia-Pacific region and India's position compared to other markets. In the next chapters, we describe how India's markets are accessed currently and provide an overview of the tax framework that applies to foreign investors in the Indian equity markets. In the last chapter, we outline the areas in which Indian equity markets could benefit from structural changes and make recommendations for the future evolution of the Indian equity markets that are based on our members' collective input.

The first sections of this paper cover both the debt and equities markets for illustration purposes and to outline the importance of capital markets in general. Our recommendations however only cover the equities markets. This paper should therefore be read in conjunction with ASIFMA's July 2017 paper "India's Debt Markets: The Way Forward, which is a comprehensive analysis on the current state of and the outlook for India's debt markets and provides detailed recommendations on how to enable India's continued strong growth.

India needs to further reform its financial market regulations and policies, reduce investment frictions and improve ease of access to encourage more foreign investors to register as FPIs and directly invest onshore. Offshore trading continues to grow on the Singapore Exchange (SGX) and Dubai Gold Commodity Exchange (DGCX), with the SGX having just launched Indian single stock futures in January 2018 as a complement to its Nifty 50 index futures, which already enjoys a higher market share than its counterpart onshore in India. We believe that the following measures will attract foreign investors to invest directly in the Indian equity markets:

- Further ease the FPI registration process, including smoothening out the current KYC challenges
- Adopt algo friendly regulations in line with global practice
- Extend the block trading window and price band
- Allow institutional friendly Stock Borrowing and Lending both for better hedging as well as to attract active investors and alpha generation
- Develop an ID market which does not preclude efficient and effective omnibus trading at the fund manager level
- Adopt tax regulations and compliance framework which are fair, transparent and effective, but not onerous
- Implement operational guidelines and clarify any pending tax matters with respect to the issuance of unsponsored Depositary Receipts
- Facilitate increased regulatory transparency and consistency through a more open consultation process

In the words of Prime Minister Modi at the World Economic Forum, Davos 2018: *Our mantra is 'reform, perform and transform'*.

B. Importance of the Capital Markets

1. Importance of capital markets supported by institutional investors

Capital markets, defined as the part of a financial system concerned with raising capital by dealing in shares, bonds and other long-term securities and derivatives investments, are of critical importance to the financial system of a country and to the country's economic development as a whole. A country's capital markets play an important role in mobilising financial resources and their allocation towards productive projects and channels. Another key element is to act as an alternative source of funding to an over-reliance on bank lending which can cause systemic risk. Strong and functioning capital markets:

- Provide a method to mobilise savings and accelerate capital formation;
- Allow for the raising of long-term capital;
- Act as an effective economic barometer;
- Offer investment opportunities for the public; and
- Enable foreign capital to enter the local economy.

The perceived benefits from having functioning capital markets include:

- Higher productivity growth;
- High real-wage growth;
- Greater employment opportunities; and
- Greater macro-economic stability.

Investors in capital markets are generally split between retail and institutional investors. Retail investors are individual investors who buy and sell on their own behalf while institutional investors are professional entities that rely on pools of money generally from third parties including retail investors to fund their transactions. Both groups of investors play a key role in financial markets but ensuring that institutional investors support the capital markets of a country is of fundamental importance, due to their size and the stability they add to the market. Institutional investors generally include investment funds, insurance companies, pension funds, treasury operations of banks, foundations and endowments and are a driving force in financial markets. They are complemented by public institutions such as central banks, sovereign wealth funds, and treasuries. In OECD countries institutional investors hold assets in excess of 60% of their country's gross domestic product (GDP)[1] and the prospects for future growth among institutional investors remain strong.

[1] OECD private pensions report, 2013

Institutional investors are traditionally seen as sources of long-term capital, given the long investment horizons they tend to have. They are increasing their exposure to alternative assets in a drive to diversify and generate higher returns on their investments and are increasing their international holdings. These trends are in conjunction with their traditional investments in equities and fixed income assets.

Increasing institutional investor participation in India's equity markets would be most beneficial, as a diversified investor base promotes stable shareholding and healthy liquidity. Institutional investors have different investment perspectives and time horizons from retail investors. They are less prone to pursuing market fads or to herding during market stress.

A country with well-developed capital markets will serve as a foundation for its domestic institutional investors to act as a source of long-term capital and entice foreign investors in with their capital and practices which can be leveraged to further develop domestic capital markets.

2. Country growth

As stated earlier, a key function of capital markets is to mobilise savings, promote liquidity, provide an infrastructure to investment and fundraising, and assist in drawing in foreign investments.

Over the period 2011-2016, India's savings rate fell from 35.5% to 30.2% which is still high by international standards. During the same period, market liquidity – measured as the turnover ratio – fell from 16.2 to 5.4 for BSE and 53.4 to 34.7 for NSE which can be attributed to increases in the market capitalisation for the two exchanges rather than decreases in turnover (Figure 1). Foreign investment in India increased from USD 33 billion to USD 45 billion. The infrastructure for effective capital markets was strengthened by the removal of the Capital Issues (Control) Act with effect from 1992, freeing-up the pricing of market issuances in both debt and equity markets, and generally favourable economic conditions including bullish stock markets, a low-interest rate environment and a positive future economic growth forecast.

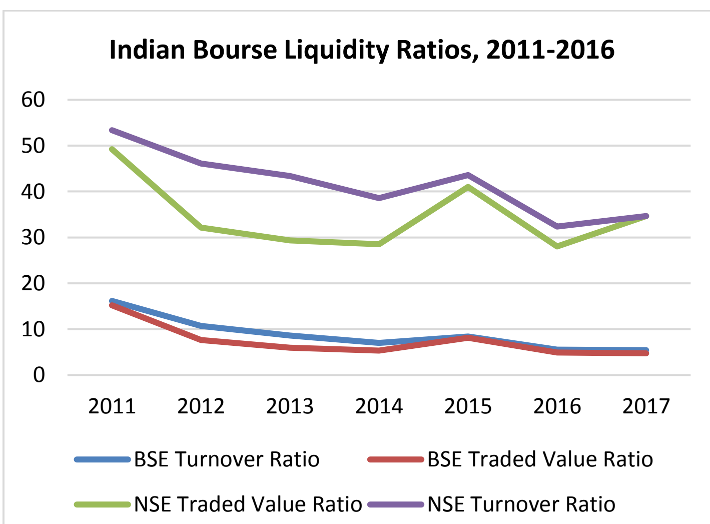


Figure 1: Indian Bourse Liquidity Ratios, 2011-201
Source: SEBI

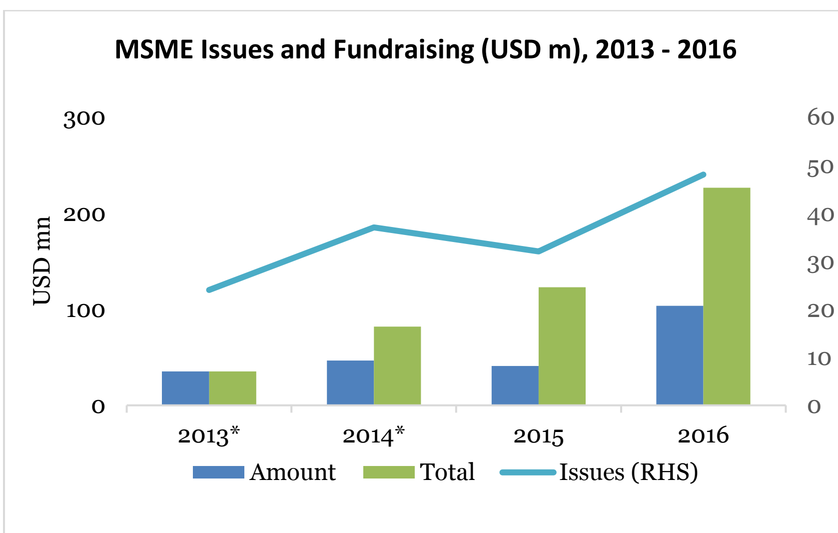
During this period, India saw increased productivity growth averaging 5.3%, whilst real-wage growth rose from 20.1% to 20.4%, unemployment fell from 3.7% to 3.6%, and the macro-economic environment was generally regarded as improving as evidenced by commentary from institutional bodies such as the World Bank.

3. Industry/corporate growth

The strength of capital markets translates into industry and corporate growth as capital flows to economic sectors that investors believe will have stronger growth prospects. Capital markets channel investment into more productive areas of the economy which in turn promotes greater economic growth and employment across an economy. Capital markets can also assist in diversifying investments across an economy, allowing entities to raise capital through debt, equity, private equity, or other means. Such diversification can serve to protect firms in general and the economy as a whole from over-reliance on one form of capital raising, i.e. debt financing through banks.

One particular group of companies which benefits from well-functioning capital markets are Micro, Small, and Medium Enterprises ("MSMEs"). Due to their size they may have a risk profile too high for commercial banks to lend to them so the capital markets enable them to undertake capital raising. Given the large proportion of MSMEs in India - they account for roughly 80% of firms, 8% of GPD, and 69% of employment - their continued ability to remain in operation is a key driver of economic growth.

Figure 2 below demonstrates the increasing number of issuances by MSMEs and their increasing fundraising activities using India's capital markets whereas previously they may have relied more of networks of friends and family to achieve their funding requirements.



**FY ending in March*

Figure 2: MSME Issues and Fundraising, 2013-2016 (USD million)
Source: SEBI

The contribution of non-MSMEs to India's GDP is overweighed compared to their MSMEs counterparts; they account for 20% of firms, 92% of GDP, and 31% of employment.

In addition, there has been a significant rise of retail investors and expansion of retail accounts in India. The number of individual folio[2] accounts in India reached 65 million; up from 55 million accounts in 1Q17[3]. While it is possible, and likely, that there are individuals with more than one folio account, the proliferation of such accounts is an indication of the growth in investors being engaged in the mutual funds industry in India – and through the mutual funds industry, capital markets in general.

Investors are also able to diversify their holdings when strong capital markets exist and can allocate assets across a range of classes to spread risk. Thus, strong capital markets serve both investors and the companies looking for financing as they seek to diversify their investments and lending channels respectively.

4. Primary market

When investors look to engage with capital markets, they generally do so through two channels; the primary market and the secondary market.

The primary market is where securities, like stocks and bonds, are created and the secondary market is where they are traded after their initial creation.

The primary market comprises three methods of capital raising:

- Public issue – Initial Public Offerings ("IPOs") and public offerings of bonds which are listed on exchanges
- Rights issues – Essentially an offer to a company's existing shareholders to buy additional securities in the company; and
- Private placement – The sale of securities to a relatively small number of select investors.

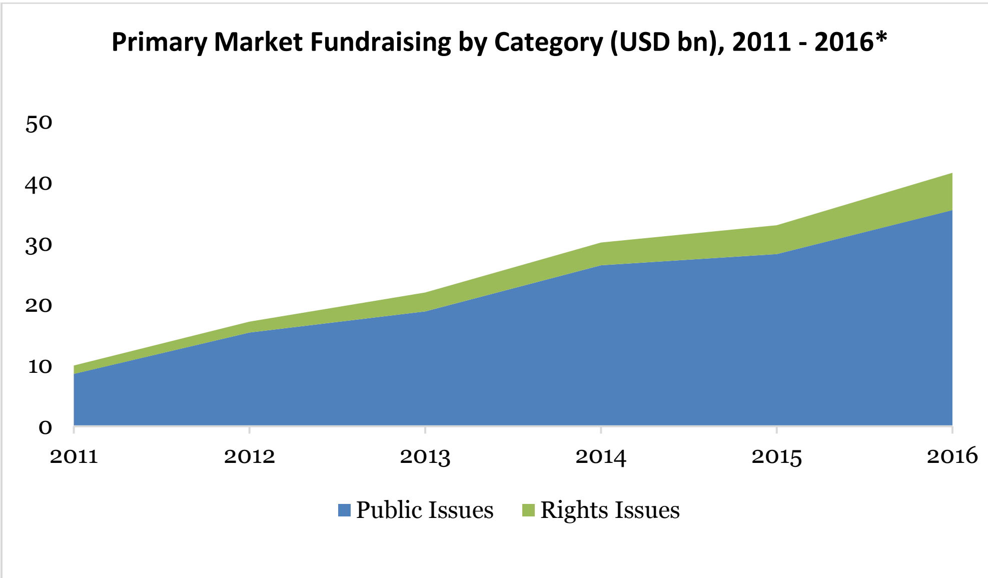
Over the period 2011-2016, India's primary market performance – relating to public issues, rights issues, and private placements – grew by 316% to reach USD 41.5 billion, up from USD 10 billion in 2011. Total issues increased from 91 in 2011 to 426 in 2016. Specifically, IPOs grew from USD 5.2 billion to USD 15.2 billion with 53 IPOs in 2011 and 245 by 2016, bonds issues increased from USD 1.39 billion to USD 21.9 billion with 10 in 2011 growing to 130 by 2016, rights issues increased from USD 1.4 billion to USD 6.1 billion with 23 in 2011 and 78 by 2016, and debt private placements grew from USD 33.3 billion to USD

2 In the mutual funds industry, a folio account is a number identifying an investor's account with the fund to uniquely identify fund investors and keep records.

3 Ignites Asia, 21/12/2017

91.9 billion from 2011-2016. Some instances of equity private placements occurred over this period but there is no comprehensive data.

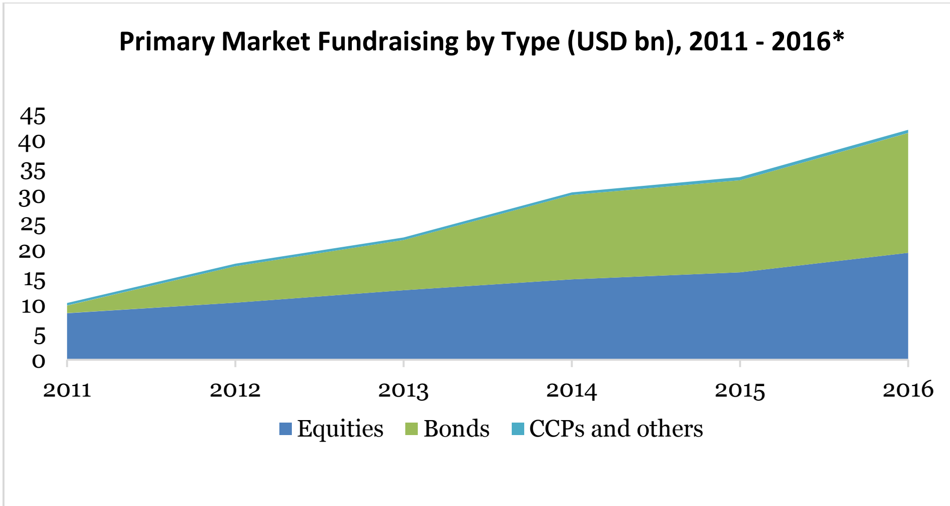
Figure 3 below shows the growth in primary market operations with public issues and rights issues.



**FY ending March for 2011-2016 figures*

Figure 3: Primary Market Fundraising by Category, 2011-2016 (USD billion)
Source: SEBI

Figure 4 on the next page shows that primary market participants are increasingly comfortable in venturing beyond simple equity issues and that investors are increasingly investing in bond issuances. The growth in diversity among primary market fundraising issuances is an indication that India's capital markets are achieving their objective of promoting diversification of capital structures and investments.



**FY ending in March for 2011-2016 figures*

Figure 4: Primary Market Fundraising by Type, 2011-2016 (USD billion)
Source: SEBI

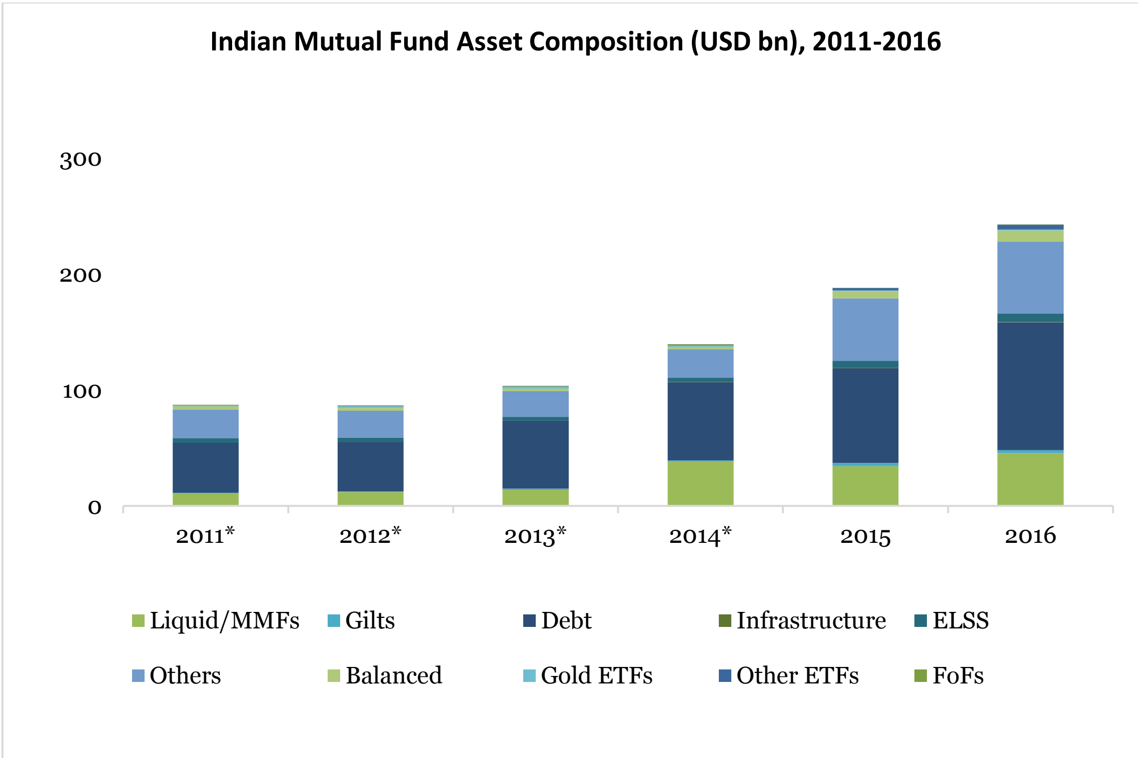
5. Funds

Over the same period, India's mutual fund Assets under Management (AUM) grew by 178%, from USD 87.3 billion in 2011, to USD 242.7 billion in 2016. The private sector share of these assets increased from 77% in 2011 to 81% in 2016, potentially indicating that India's capital markets are achieving one of their objectives of increasing participation among sections of society that may not have participated previously.

Assets managed by portfolio managers grew by 224% from USD 53.5 billion in 2011 to USD 173.3 billion in 2016. The vast majority, 74% in 2011 and 78% in 2016, of these assets are held in discretionary accounts. Client numbers of portfolio managers fell by 8% over the same period, from 79,180 in 2011 to 72,477 in 2016. Discretionary clients remained the vast majority of clients, accounting for 85% in 2011 and 91% in 2016.

Figure 5 demonstrates the changing composition of Mutual Fund AUM in India. It is interesting to note the increase in AUM allocated towards debt in line with the increase in debt issuance on the primary markets shown in Figure 4.

The increase in liquid / money market fund (MMF) allocations could be seen as further confidence in the development of India's capital markets as mutual funds feel these products are performing their short-term nature in the Indian economy and helping lubricate the levers of finance which capital markets are dependent on to function.



**FY ending in March for 2011-2014, 2015 and 2016 figures are as of December.*

Figure 5: Indian Mutual Fund Asset Composition, 2011-2016 (USD billion)
Source: SEBI

Mutual funds have benefited from a low interest rate environment from high savings deposits, and investors in smaller cities and towns have sought higher returns. Efforts by regulators to incentivise asset and wealth managers to focus on smaller cities and increase investor education regarding mutual funds have also contributed.

6. Secondary market

India's secondary market performance (including equities and debt) – where investors trade securities already issued in the primary market, usually via an exchange such as the National Stock Exchange (NSE) or Bombay Stock Exchange (BSE) – grew by 30% to reach USD 1.8 billion in 2016, up from USD 1.4 billion in 2011. Specifically, the market capitalisation of the BSE and NSE grew from USD 916.1 billion and USD 898.6 billion to USD 1.6 trillion and USD 1.5 trillion respectively. The securities turnover for the exchanges grew over the same period from USD 112.5 million and USD 47.3 billion to USD 493.2 million and USD 125.5 billion respectively. Equity derivatives grew from an aggregate of USD 4.3 trillion across the NSE and BSE in 2011, to reach USD 9.8 trillion in 2016 while aggregate contracts stayed around the 1 billion mark over the same period. India's domestic corporate debt market has also grown, with turnover increasing from USD 89.2 billion in 2011 to USD 152.8 billion in 2016, and with trades increasing from 44,043 to 348,620 over the same period.

The growth in the two pillars of India's capital markets, in addition to other benefits related to a well-functioning capital markets, bode well for India's financial development.

C. Capital Markets in Asia-Pacific

1. Capital market in India, 2012-2016

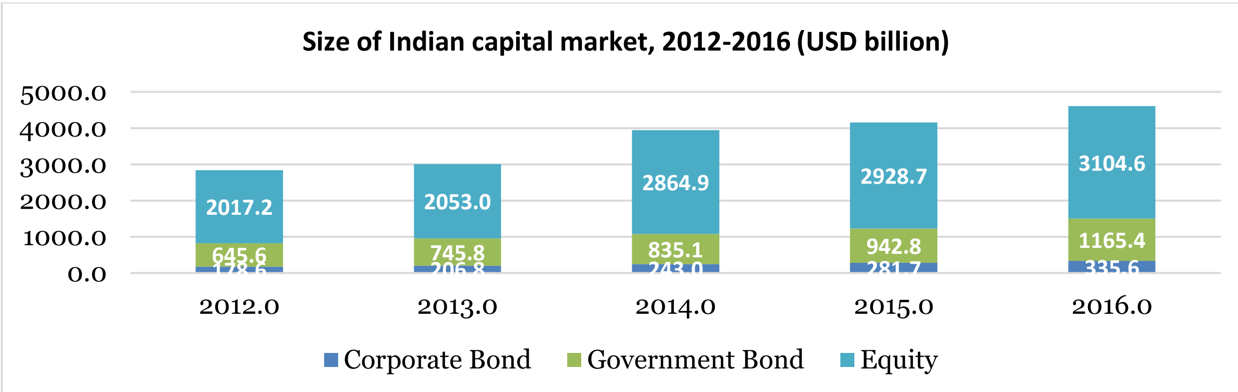


Figure 6: Size of Indian capital market relative, 2012-2016 (USD billion)
Source: SEBI, CCIL, NSE, BSE

The Indian capital markets have grown year-on-year since 2013, and saw their largest growth of 31.2% in 2014, driven largely by gains in the equity market. Both the equity market and the debt market – comprising of both government and corporate bonds – has been growing steadily from 2012 to 2016.

As of 2016, the Indian capital market stood at USD 4.6b trillion, with the equity market comprising 67.4% of the entire market. Year-on-year, the equity market grew by 6.0%, compared to the bond market's 22.6%.

2. Comparison of capital markets in the APAC region

a. Size of equity market relative to GDP in selected economies, 2016

Among countries in the Asia-Pacific region, the Japanese Exchange Group had the highest market capitalisation, of USD 5 trillion in 2016, whilst the total market capitalisation of the NSE and BSE stood at USD 1.6 trillion and USD 1.5 trillion, respectively.

As a proportion of GDP, India's total equity market capitalisation was 139%, trailing only Hong Kong, Singapore, and Taiwan in the region. This is comparable to that in the US of 147% and much higher than in European countries such as Luxembourg and Germany.

b. Size of local currency bond market relative to GDP in selected regional economies, 2016

Market	Government debt (% of GDP)	Corporate debt (% of GDP)	Total debt (% of GDP)
Japan	195%	15%	209%
Korea	52%	74%	126%
Malaysia	51%	43%	95%
Singapore	47%	35%	82%
Thailand	55%	20%	75%
Hong Kong	43%	31%	74%
India	52%	15%	67%
China	46%	20%	66%
Philippines	27%	6%	34%
Vietnam	21%	1%	22%
Indonesia	15%	3%	18%

Table 1: Size of local currency bond market relative to GDP in selected regional economies, 2016
Sources: Asian Bonds Online, SEBI, CCIL, IMF

In 2016, India's government debt was more than three times the size of the corporate bond sector, standing at USD 1.2 trillion and USD 335.6 trillion, respectively. In absolute terms, India's local currency debt market was the fourth largest in APAC, trailing Japan (USD 9.6 trillion), China (USD 7.1 trillion), and Korea (USD 1.7 trillion). However, as a proportion of GDP, India's bond market ranks seventh among the eleven selected countries in the Asia-Pacific region, and in particular the corporate bond markets are significantly underdeveloped.

c. Investment flows channelled through exchanges

Country	IPOs	Already listed Companies	Total
China *	7.2	154.1	161.3
Hong Kong	25.2	38.0	63.1
Japan	7.5	15.6	23.1
India **	4.5	14.2	18.7
Australia	6.3	8.1	14.5
Thailand	0.9	5.1	6.0
Korea	5.4	-	5.4
Indonesia	0.9	3.2	4.1
Taiwan***	0.8	3.2	4.0
Singapore	1.7	2.0	3.8
Malaysia	0.2	3.0	3.1
Philippines	0.6	-	0.6

Table 2: Investment flows through selected regional stock exchanges, 2016 (USD billion)
Source: WFE

** Only includes Shanghai Stock Exchange*

*** Includes both BSE and NSE*

**** Includes both Taipei Exchange and Taiwan Stock Exchange*

In 2016, the Shanghai Stock Exchange led the Asia-Pacific region with USD 161.3 billion in total investment flows from IPOs and existing listed companies. Moreover, much of Hong Kong's flow can be attributed to China as well. India, on the other hand, netted the fourth highest investment flows among countries, of USD 18.7 billion in 2016 from NSE (USD 18.3 billion) and BSE (USD 0.4 billion), respectively.

As a whole, funds raised through IPO activities in India shrank 19.5% year-on-year standing at USD 4.5 billion.

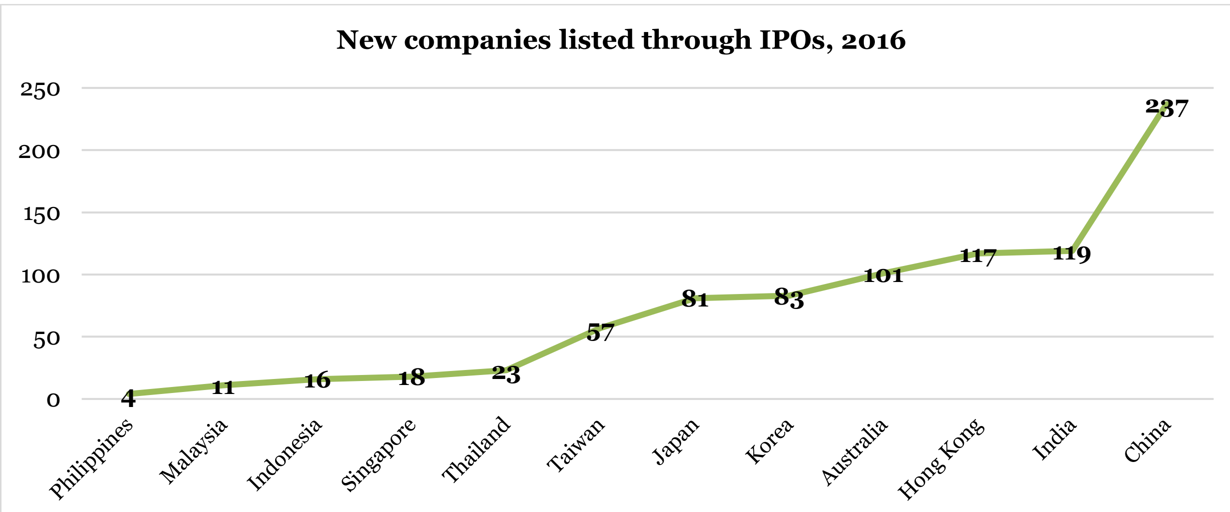


Figure 7: New companies listed through IPOs, 2016
Source: WFE

During 2016, India had one of the highest number of IPO listings – 70 new firms were listed on the BSE, and 49 went public on the NSE. These listings raised the total number of listed companies on India's exchanges to 7,761, the largest number of listings in the Asia-Pacific region. Japan and China, on the other hand, have 3,541 and 3,052 companies listed respectively. However, one challenge with having more listings but not a larger overall market capitalisation is that India has fewer larger cap firms and therefore, stocks in Indian by definition would be less liquid and of less interest to institutional investors, particularly foreign.

d. Performance of key indices

	Index	2016 year-end	1 year returns	3 year returns
Hong Kong Exchanges and Clearing	**S&P/HKEX Large Cap Index**	27926	3.4%	-0.7%
BSE Limited	**S&P BSE SENSEX**	26626	1.9%	25.8%
Bursa Malaysia	**FBM Emas Index**	11467	-2.8%	-10.8%
Taiwan Stock Exchange	**TAIEX**	9254	11.0%	7.5%
National Stock Exchange of India	**Nifty 50**	8186	3.0%	29.9%

NZX Limited	**S&P NZX ALL**	7449	9.6%	41.5%
The Philippine Stock Exchange	**PSE Index (PSEi)**	6841	-1.6%	16.1%
Colombo Stock Exchange	**CSE All Share**	6228	-9.7%	5.3%
Australian Securities Exchange	**S&P/ASX All Ordinaries**	5719	7.0%	6.8%
Indonesia Stock Exchange	**JSX Composite Index**	5297	15.3%	23.9%
Shanghai Stock Exchange	**SSE Composite Index**	3104	-12.3%	46.7%
Singapore Exchange	**FTSE Straits Times Index**	2881	-0.1%	-8.0%
Korea Exchange	**KOSPI**	2026	3.3%	0.8%
Shenzhen Stock Exchange	**SZSE Composite Index**	1969	-14.7%	86.2%
Stock Exchange of Thailand	**SET Index**	1543	19.8%	18.8%
Japan Exchange Group	**Topix**	1519	-1.9%	17.7%
Hochiminh Stock Exchange	**VN Index**	665	14.8%	33.6%
Taipei Exchange	**TPEx index**	125	-3.0%	-3.4%
Average returns			2.4%	18.8%

Table 3: Performance of various indices in Asia-Pacific 2016
Sources: WFE, BSE

The S&P BSE Sensex and NSE NIFTY 50 closed 2016 at 26,626 and 8,186points respectively, growing by 1.9% and 3.0% respectively over the year. Between 2013 and 2016, both indices saw a growth of 25.8% and 29.9%, respectively.

Among regional economies, the Stock Exchange of Thailand Index had the most remarkable year, ending 2016 on a high of 1,543 points, up from 1,288 points in 2015. Meanwhile, the benchmark composite indices in Shenzhen and Shanghai had one of their worst years, falling by -14.7% and -12.3% respectively.

e. Derivatives market

Exchange	Vol. of stock option contracts (USD million)	Notional value (USD billion)
National Stock Exchange of India	88.8	792.7
Australian Securities Exchange	85.2	140.5
Hong Kong Exchanges and Clearing	70.1	163.0
Korea Exchange	11.6	N/A
Japan Exchange Group	0.8	N/A
TAIFEX	0.3	0.6
BSE Limited	0.1	0.8

Exchange	Vol. of single stock futures contracts (USD million)	Notional value (USD billion)
National Stock Exchange of India	172.7	1,468.8
Korea Exchange	172.1	106.3
Thailand Futures Exchange	33.8	N/A
TAIFEX	10.0	50.4

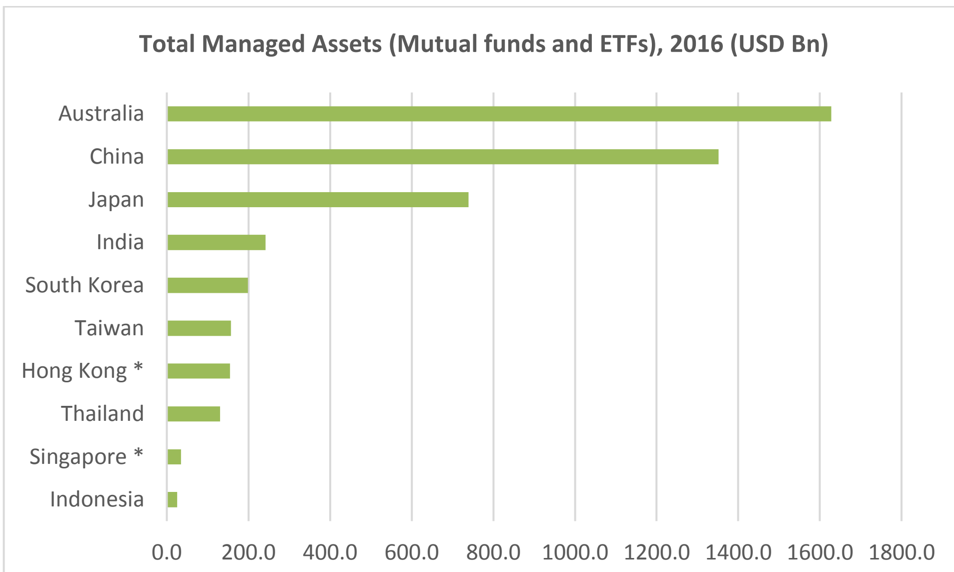
Australian Securities Exchange	4.7	4.3
Hong Kong Exchanges and Clearing	0.2	0.7
BSE Limited	0.004	0.03

Excluding China - Following the crash of 2015, China virtually banned the trading of index futures to prohibit shorting of the market. Trading amounts were restricted, and fees increased substantially to discourage trading.

Table 4: Volume of equity derivatives in selected regional economies, 2016
Source: WFE

India is one of the most vibrant marketplaces in Asia-Pacific for equity derivatives. In 2016, the NSE led the region with the highest volume of stock options worth USD 792.7 billion. In addition, the notional value of single stock futures traded on the NSE was the highest in the region, standing at USD 1.5 trillion, more than ten times that in the second largest market, South Korea (USD 106.3 billion).

f. Mutual funds



**Hong Kong and Singapore data are for the onshore market only.*

Figure 8: Total APAC Managed Assets (Mutual Funds and ETFs) by market
Source: Various local regulatory bodies, Morningstar

With respect to mutual funds and exchange-traded funds (ETFs) which serve as a good proxy for the level of institutional investor activity, India has a respectable market showing managed assets larger than that of Hong Kong, Korea, Taiwan and Singapore. Although, if taken within context to relative size of GDP, it becomes clear that there is potential for significant future growth.

However, from a cash equities trading perspective, Indian markets still trade quite poorly. Cash trading to GDP is among the lowest compared to other large markets.

The ratios of equities cash trading volumes to GDP as of the end of September 2017 is shown in table 5 below. India is the least active in trading volume after Brazil which indicates there are still a number of market reforms that need to be undertaken in the market structure to encourage a more liquid market.

Country	Cash Trading Volume to GDP
China	162%
United States	133%
Switzerland	131%
Japan	116%
Korea	110%
Taiwan	110%
United Kingdom	106%
Canada	73%
Australia	58%
Spain	55%
Germany	36%
India	33%
Brazil	24%

Table 5: Cash trading volume to GDP
Source: World Federation of Exchanges and IMF

D. Accessing India's Capital Markets

1. Growth potential of India's capital markets

India's capital markets have significant growth potential. As mentioned earlier, equity cash trading and mutual funds / ETFs have significant upside potential.

2016 saw significant progress with the Nifty 50 reaching the 10,000 mark driven largely by strong flows into emerging markets, government reforms, a good monsoon season, and a positive global outlook. From a fundamental perspective, India's economy doubled from 2003-2007, and again from 2007-2015. Market growth, across both the BSE and NSE, reflected this economic growth and remain poised to continue to do so off the back of India's demographics and consumption-based economy.

2. Overall tax and regulatory environment needs improvement

One impediment cited by FPIs which may discourage more active investment in India are the trading frictions which exist due to cumbersome regulations and tax policies. PWC's Foreign Portfolio Investor Survey 2016-17 showcases respondents' satisfaction with specific issues related to India tax and regulations, rates on capital gains, outcome of the (Minimum Alternate Tax) MAT controversy, tax audits, and the regulator's responsiveness. However, an assessment of the overall environment would be incomplete without taking stock of the other aspects of tax and regulation, which might not necessarily be a pocket of strength. For instance, the FPI registration process and KYC requirements, despite the government's current initiatives, could benefit from further easing. We will go into further detail on these recommendations in section F.

When asked about the overall regulatory and tax environment, 77% and 81% of the respondents, respectively, found them to be challenging relative to other emerging markets. The report recommends that regulators should look at further easing the FPI registration process by rationalising the criteria for registration and KYC norms.

3. Directly accessing the Indian capital markets onshore – Types of foreign investors

Currently, foreign institutional investors are able to access Indian capital markets through portfolio investments as either FPI, as a Foreign Venture Capital Investor (FVCI) or as a Foreign Direct Investor (FDI) for strategic investments.

FPIs are required to be registered and this is delegated from SEBI to Designated Depositary Participants (DDPs). FVCIs need to be registered with SEBI, but FDIs do not need to undergo registration.

The product options open to each foreign investor segment are outlined in the table below:

Market Segment	Instrument type	FPI	FDI	FVCI
Equity market	Listed equity	✓*	✓*	✓
	Unlisted equity	No	✓	✓*
	Preference shares	✓	✓	✓
	Warrants	✓	✓	✓
	Partly paid shares	✓	✓	No
	Units of mutual funds	✓	No	No
Fixed income	Dated government securities	✓	No	No
	State development loans	✓	No	No
	Treasury bills	No	No	No
	Commercial paper	No	No	No
	Certificates of deposit	No	No	No
	Corporate bonds	✓*	✓*	✓*
Derivative contracts	Index futures	✓	No	No
	Index options	✓	No	No
	Stock futures	✓	No	No
	Stock options	✓	No	No
	Interest rate futures	✓	No	No
	Currency derivatives	✓	No	No
Others	Others	✓*	✓*	No

Table 6: Allowed instrument type per investor segment
Source: PWC

FPIs are further segmented into one of three categories as part of a risk based approach KYC process:

- Category I (Low Risk): typically government or quasi-governmental entities like central banks, Sovereign wealth Funds, Multilateral Organizations, etc.
- Category II (Moderate Risk): typically regulated entities such as banks, pension funds, insurance companies, mutual funds, investment trusts, asset management companies, etc.
- Category III (High Risk): all other FPIs not eligible under Category I and II such as endowments, charitable societies, charitable trusts, foundations, corporate bodies, trusts, individuals and family offices.

4. Accessing the Indian capital markets from offshore: Access products (swaps, P-notes, cash, stock futures)

a. What are access products?

Access products are instruments that allow an investor to take economic exposure to various global markets. Some investors, who do not wish to register with the local regulator and be subject to local tax and regulatory compliance requirements, approach issuers of access products for taking indirect exposure to such markets.

There are different types of access products to suit the type of exposure that investors wish to take in one or more jurisdictions. However, in essence, such access products represent underlying assets that may be of different classes, or represent a portfolio of assets. Access products and their underlying asset may not correspond to each other, and the access products may not be fully hedged. The access products are always cash settled and do not permit delivery of the underlying assets. An investing entity offers access products to its clients (potential investors) to enable them to take exposures in various financial markets.

Taking exposure through access products in a country's capital market and not directly is quite popular for the following reasons:

- Investing through access products allows investors to offset their exposure in various markets in which they have invested and consequently, allows them to do a 'net settlement' of their outstanding positions. Net settlement is useful because it allows clients to mitigate / manage foreign exchange and the related settlement / operational risks.

- Access products enable investors to deal in a single currency, reduce costs and minimise intervention of various intermediaries. Incidentally, investors also get services of a single relationship person and an overall portfolio overview for exposures across markets. They also allow investors to get familiar with a market before moving onshore with its requisite additional costs and compliance burden.

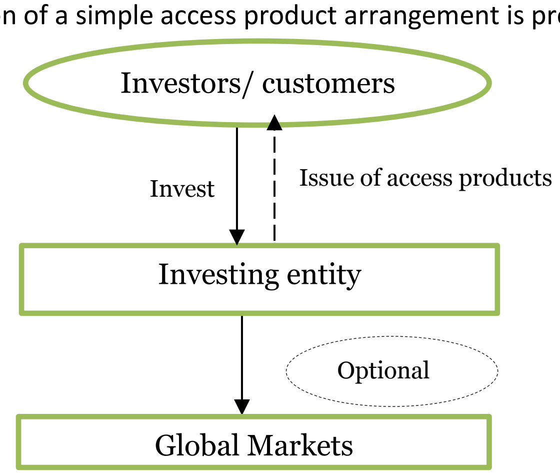
- There is no requirement to appoint intermediaries such as brokers, clearing houses, bankers and tax consultants, resulting in substantial saving of the costs.

- Reduced tax or regulatory compliances.

In addition to the above, there may be certain restrictions in the exchange control regulations that may pose challenges in making direct investments.

A detailed overview of the different types of access products can be found in Annex A.

A diagrammatic representation of a simple access product arrangement is provided below:



- The investing entity is the issuer of the access product. The investing entity may, at its discretion, decide to hedge by taking a position in the underlying securities.

- The investing entity continues to be the legal owner of the underlying assets. The investors / customers do not have any right or interest in the underlying assets held by the investing entity. Also, the investee entity would recognise the investing entity as the holder of its securities.

- The rights of investors / customers in the access products are not related to, or dependent upon, the existence or otherwise of any underlying investments in the investing entity. For example, if the investing entity were to become bankrupt, the investors / customers would have no rights or legally enforceable interest in the underlying assets.

b. Regulations governing access products (Participatory Notes or P-notes) in India

Certain categories of FPIs registered with SEBI are permitted to issue ODIs (also known as Participatory Notes or P-notes) in accordance with the SEBI (Foreign Portfolio Investors) Regulations, 2014 ('FPI Regulations'). The FPI Regulations provide that ODIs can only be issued: (a) to those persons who are regulated by an 'appropriate foreign regulatory authority', and (b) after compliance with 'know your client' norms. Accordingly, an eligible FPI seeking to issue ODIs to any person must be satisfied that such person meets these two tests. The FPIs issuing ODIs are required to put in place necessary systems to ensure compliance with the regulations and the reporting requirements.

Over the last few years, SEBI has consistently attempted to increase the transparency around issuance of P-notes. Some measures include:

- Category III (and certain Category II) FPIs are not allowed to deal in P-notes;

- P-notes are allowed to be issued only to those entities which are regulated by an appropriate foreign regulatory authority;

- Issuers of P-notes also have to satisfy the KYC norms before issuing a P-note;

- FPIs are required to ensure that P-notes are not issued or transferred to resident or non-resident Indians;

- Resident of non-compliant Foreign Action Task Force countries are barred from holding P-notes;

- Opaque structures (where the details of the UBO are not accessible or they were ringfenced with regard to enforcement) are barred from holding P-notes.

However, the primary concern of the regulator was that all these measures were targeted only at the first level issuer. There was only one major requirement for subsequent transfer being that the transfer could be made only to regulated entities. Therefore, SEBI did not have much control and information about subsequent transfers of P-notes. It was perceived that it may be easy for players to have layered structures behind which they could hide the UBOs.

In June 2016, based on the recommendation of the Special Investigation Team set up by the Supreme Court of India, SEBI issued further guidelines and put in place a mechanism to understand the identity of the UBO of the ODIs. Below are some of the conditions/ compliance requirements introduced by SEBI:

- ODI issuers required to identify and verify the Beneficial Owner (BO) in the subscriber entities who holds stakes beyond prescribed thresholds, i.e. 25% in case of a company and 15% in case of partnership firms/trust/unincorporated bodies;

- If no material shareholder is identified, the identity and address proof of the relevant natural person who holds the position of senior managing official of the material shareholder/owner entity should be obtained;

- ODI subscribers will have to seek prior permission of the original issuer for further/onward issuance/transfer of ODIs unless the person to whom the ODI are transferred to are pre-approved by the FPI;

- Risk review to be done at the time of onboarding and once every three years for low risk clients. In respect of all other clients, risk review is to be done at the time of onboarding and every year thereafter;

- ODI issuers are required to file suspicious transaction report with Indian Foreign Investigation Unit, if any, in relation to ODI issued by them;

- ODI issuers are required to carry out reconfirmation of ODI position on a semi-annual basis;

In order to further enhance the transparency in the process of issuance and monitoring of ODIs being issued by the FPIs registered with SEBI, SEBI has in July 2017 undertaken the following measures:

- Prohibit ODIs from being issued against derivatives except for those used for hedging: SEBI, vide circular dated 7 July 2017, prohibited ODI issuing FPIs to issue ODIs with derivative as underlying (with the exception of those derivative positions that are taken by the ODI issuing FPI for hedging the equity shares held by it on a one-to-one basis i.e. where the derivatives have the same underlying as the equity share).

- Imposition of regulatory fees on FPIs issuing ODIs: SEBI, vide notification dated 20 July 2017, amended the FPI Regulations and imposed regulatory fees of USD 1,000 on each ODI issuing FPI for each and every ODI subscriber coming through such FPI. These fees will be levied for a period of every three years. This provision is primarily to discourage the ODI subscribers from taking the ODI route and encourage them to directly take registration as an FPI, since it was observed that quite a few ODI subscribers invest through multiple issuers.

c. Taxation of access products (P-notes) in India

P-notes are contractual arrangements between two parties, one of which is an offshore entity registered as FPI, holding underlying securities. P-notes usually do not confer any interest or title in the underlying security to the P-note subscriber/ holder. Even though there are no express provisions regarding taxability on transfer/ redemption of P-notes, in a typical P-note issuance as discussed above, there should not be any India tax implications.

GAAR provisions have been made effective 1 April 2017. The law provides that GAAR provisions are not applicable to investments made by non-residents in P-notes issued by FPIs. GAAR provisions empower Indian tax authorities to consider any transaction as an 'impermissible avoidance arrangement' where the main purpose of the arrangement is to obtain a tax benefit.

d. Impact of regulations on ODI market

The regulator in India has time and again been extremely sensitive to investments made in the country by way of ODIs/P-Notes in view of their anonymity and, as mentioned above, has frequently amended regulations for tightening the ODI/P-Notes norms.

Evidently, investments via P-notes as a percentage of FPI flows have been falling over the years. Their contribution to total FPI flows in India was at an all-time high of 55.7% in June 2007, and fell to 15.1% in December 2010. As of March 2017, it was a mere 6.6% of the total FPI flows and it fell further to 4% by November 2017. This fall can be attributed majorly to the tightening of norms on black money by the Indian government as well as imposing various regulatory requirements on FPIs issuing the ODIs/P-Notes.

5. Comparison with access programs in other Asian jurisdictions

Many economies have adapted temporary conduits, which are ultimately sub-optimal for investment purposes, on their path to having fully-open capital markets allowing direct investment by institutional investors. While different countries follow different methods of access, India's measures to restrict the use of access products may be overstated and stifle genuine investment. We recommend that the measures be balanced with the need for ease of doing business in India.

a. Taiwan

Foreign institutional investors have been able to invest in Taiwan's capital markets since 1983 when Taiwanese investment trust companies were permitted to solicit overseas capital for investment in Taiwan's domestic stock market. In 1991, this was expanded to allow qualified foreign institutional investors to apply to Taiwan's Central Bank to invest directly on the Exchange via a Qualified Foreign Institutional Investor (QFII) account subject to an investment ceiling (later removed). The QFII application process was then replaced by a streamlined registration process via the Taiwan Stock Exchange to secure Foreign Institutional Investor (FINI) accounts. Repatriation controls were relaxed, and securities lending was reformed to become better aligned with international practice. Foreign institutional investors have become significant players in the Taiwan market which has helped to bolster the capital markets there.

b. Korea

Korea's capital markets are generally regarded as being globalised and open thanks to the process of opening-up that capital markets went through starting from 1981 when the government announced a four-phased Capital Market Globalisation Plan which included the introduction of the Korea International Trust and Korea Trust as investment vehicles for foreign portfolio investors.

Foreign investors have been able to access Korean securities since 1992 and their numbers and participation in Korea's capital markets have steadily increased since then. Foreigners are allowed to acquire all securities available in Korea, though there are ceilings on foreign investment for certain companies like public utilities and SOEs.

For foreigners to hold domestic securities they need to create an external account for the exclusive trading of securities and a non-resident KRW account for the same purpose under their own name. They then need to register as a foreign investor at the Financial Supervisory Service and receive an investor registration number. They can then nominate a permanent agent to place their orders through securities companies.

c. China

China offers foreign institutional investors multiple channels through which to invest in its capital markets. Chinese mainland companies listed in Hong Kong are known as "Red Chips" or H shares, traded via the Hong Kong Exchanges and Clearing Limited (HKEX) and settled in HKD. In recent years, more and more Chinese companies have also been directly listing in the US and other markets to tap into offshore capital markets. On the domestic bourse, there are two share classes: A shares which are traded on the local exchanges (Shanghai and Shenzhen) and which settle in RMB, and B shares which are also traded on the local exchanges but which are settled in USD. China launched its Qualified Institutional Investor programme (QFII) in 2002, which is a license and quota scheme, through which institutional investors can invest directly onshore and invest in China A shares via the Shanghai or the Shenzhen Stock Exchange.

As of December 2017, a total of USD 97.159 billion had been allocated in QFII quota. China maintains a "closed" capital account, which means investors can move money into and out of China only subject to strict rules. Per earlier mention, Chinese authorities have been gradually opening its capital markets, via tightly controlled programs like the QFII scheme, to allow some foreign participation in China's capital markets. In November 2014 China inaugurated Shanghai-Hong Kong Stock Connect, opening a low friction portal to China's largest stock exchange to foreign investors. The launch of Shenzhen-Hong Kong Stock Connect on 5 December 2016 opened a similar channel to China's second stock exchange, home to listings of mostly smaller-cap, faster growing Chinese companies.

The typical route for investors in one country to buy stocks in another country is via a relationship between the broker in the originating country and a correspondent broker in the target country. Stock Connect, by contrast, is a direct link between exchanges. The original link, launched in November 2014, enabled brokers who are members of HKEX to execute “Northbound” orders for customers through a link to the Shanghai/Shenzhen Stock Exchange (SSE/SZSE) itself, rather than to brokers who are members of the SSE/SZSE in China. The HKEX has an omnibus account at the SSE/SZSE (or to be precise, with its clearing entity Chinaclear) containing all the shares of the HKEX members who participate in the link. The link is symmetrical, allowing investors in China to trade HKEX stocks “Southbound” via Chinese brokers who are members of the SSE/SZSE.

The Stock Connect link enables the Chinese authorities to allow money to flow into (and out of) Chinese shares in a way which they can control because it all flows through this single conduit. Crucially, when an investor who bought shares via Stock Connect sells them, the RMB proceeds are delivered in Hong Kong. Investors wishing to buy Chinese shares have to purchase RMB in Hong Kong (technically they purchase offshore RMB, or CNH), not on the mainland, or have their broker arrange to purchase the RMB for dollars or other currency for them. Thus Stock Connect forms a “closed loop”, segregating RMB used to buy Chinese shares from the rest of the Chinese economy.

E. Taxation

1. Background and overview

India follows a source basis of taxation in respect of income arising to non-residents (including FPIs). This is unlike a lot of developed as well as emerging economies, that do not impose capital gains tax on portfolio investments. Due to the applicability of tax, the capital gains tax regime applicable to FPIs is relatively complex. However, over the years, the Government of India has endeavored to provide a stable regime for taxation of FPIs. The Indian tax law has a self-contained code which provides a concessional tax framework for FPIs in India. This was progressively liberalized with the removal of taxes on long-term capital gains on shares. The domestic tax rates are further subject to beneficial tax rates, if any, provided in a Double Taxation Avoidance Agreement (DTAA). India has entered into DTAAs with various countries such as Mauritius and Singapore, which provided for capital gains tax exemption to non-residents (including FPIs). These jurisdictions have accounted for a significant inflow of foreign investments into India[4]. However, in the recent past, in line with the objective to prevent double non-taxation, the Government of India has amended tax treaties with various countries including Mauritius, Singapore, Cyprus, etc. making capital gains on shares now taxable. This section presents an overview of the taxation system applicable to FPIs.

2. Overview of taxability in India

a. Charge of tax

With respect to non-resident taxpayers, India follows a source basis of taxation. Accordingly, foreign investors, being non-residents as per the Indian tax law, are subject to tax in India on their India sourced[5] income or income received in India.

b. Tax framework

A foreign investor being a FPI typically earns the following types of income on account of its investments in the Indian equity capital markets:

- Dividend income: Dividend distributed by an Indian company is exempt from tax in the hands of the recipient shareholder[6].

[4] Source: http://dipp.nic.in/sites/default/files/FDI_FactSheet_Updated_September2017.pdf

[5] Income is said to be sourced from India if it accrues or arises or is deemed to accrue or arise in India.

[6] The Indian company paying the dividend is subject to a dividend distribution tax (DDT) at the rate of 15% (plus applicable surcharge and education cess). DDT is required to be computed by grossing up the dividend payable. The effective rate of DDT following the grossing-up mechanism would be 20.358% (the Finance Bill, 2018 proposes to levy Health and Education Cess at the rate of 4% instead of the education cess of 3%. Accordingly, rate of DDT would be 20.5553%, effective 1 April 2018).

- Income distribution from equity oriented mutual funds[7]: Distribution of income by an equity oriented mutual fund to its unitholders is exempt from tax in the hands of the unitholders. The Finance Bill, 2018 proposes to levy tax on income distribution at the rate of 10%, effective 1 April 2018.

- Capital gains earned from the transfer of equity shares, equity oriented mutual funds and exchange traded derivatives (collectively referred to as 'securities') are subject to tax. Any investment in securities made by FPIs in accordance with SEBI FPI Regulations shall be regarded as a capital asset. Accordingly, income earned by FPIs from transfer of such Indian securities would be taxable as "capital gains".

3. Tax administration and compliance

a. Obtain a PAN

To commence investment activities in India, an FPI is required to obtain an alphanumeric tax identification number i.e. PAN from the Indian tax authorities. The application for PAN has to be filed along with documentary evidence for identity and address of the applicant.

b. Withholding tax and self-discharge of taxes

No deduction of tax is required from income by way of capital gains arising to FPIs from transfer of securities. The FPI will need to self-discharge taxes on its income, prior to remittance or on quarterly advance tax due dates, whichever is earlier. Delay/ deferment in deposit of advance tax has interest implications.

4. Types of tax

a. Capital gains tax

Taxability of capital gains earned by a FPI on transfer of securities broadly depends on:

- The legal status of a FPI;
- Whether Securities Transaction Tax (STT) has been paid on purchase and/ or sale;
- The period for which the securities were held prior to their transfer (depending on the period held, the gains can be classified as short-term capital gains or long-term capital gains)

b. Minimum Alternate Tax (MAT)

Companies (including foreign companies) liable to tax in India are required to pay tax at the higher of the normal domestic tax law provisions and 18.5% of book profit[8]. However, as per a recent amendment, a foreign company is not liable to pay the tax under the MAT provisions in a scenario where:

---

[7] A fund is treated as an equity oriented mutual fund if more than 65% of its investible funds are invested in equity shares of domestic companies.

[8] Book Profit is essentially the profit as shown in the profit and loss account of the company and further adjusted by certain additions and deletions as prescribed under the provisions of the Indian tax law.

- The foreign company is a resident of a country with which India has entered into a DTAA and it does not have a permanent establishment (PE) in India in accordance with DTAA; or

- The foreign company is a resident of a country with which India has not entered into a DTAA and such foreign company is not required to seek registration in India under any law in force that relates to companies.

c. Securities transaction tax

Securities transacted on a Recognized Stock Exchange in India are subject to levy of STT as follows:

Transaction	Rates	Payable by
Purchase and sale of equity shares on the stock exchange	0.100%	Purchaser/ Seller
Sale/ redemption of units of equity oriented mutual fund	0.001%	Seller
Sale of an option in security on the stock exchange where option is not exercised	0.050%[9]	Seller
Sale of an option in security where option is exercised on the stock exchange	0.125%[10]	Purchaser
Sale of a future in securities on the stock exchange	0.010%	Seller

Table 7: Securities transaction tax overview
Source: EY

5. Short-term and long-term capital gains and tax rates

The below table indicates the manner in which capital gains, arising from transfer of equity shares of Indian companies or units of an equity oriented mutual fund or exchange traded derivatives, can be classified as long-term or short-term in nature:

Source of Income	Period of holding	Type of gain/ loss
Capital gains/ loss arising from the transfer of listed equity shares/ units of an equity orientated mutual fund/ other listed securities	12 months or less before date of sale	Short-term
	More than 12 months before date of sale	Long-term

Table 8: Short-term and long-term capital gains tax holding period overview
Source: EY

[9] STT would be computed on the amount of option premium.

[10] STT would be computed on the settlement price.

The tax rates currently applicable to FPIs on capital gains arising from transfer of equity shares of Indian companies, units of equity oriented mutual funds and exchange traded derivatives are provided in the table below:

Type of security sold	**Tax on long-term capital gains (Refer Note 1 and Note 2)**	**Tax on short-term capital gains (Refer Note 1 and Note 2)**
Capital gains on transfer of listed equity shares/ equity oriented mutual fund (STT is paid on purchase and/ or sale)	NIL (Refer note 3 and note 4)	15%
Capital gains on transfer of listed equity shares/ equity oriented mutual fund (STT is not paid on purchase and/ or sale)	10%	30%
Sale of exchange traded derivatives (i.e. listed future and options)	Not applicable	30%

Table 9: Short-term and long-term capital gains tax rates
Source: EY

Note 1: The tax rates mentioned above are subject to relief under a DTAA, as applicable. To avail DTAA benefits, a non-resident is required to obtain a Tax Residency Certificate (TRC) confirming its residency under the DTAA from the home country tax authorities and maintain a self-declaration (in Form 10F) where the TRC does not contain the prescribed information.

Note 2: In case of corporate taxpayers, a surcharge of 2% (where total taxable income exceeds INR 10 million but not INR 100 million) or 5% (where total taxable income exceeds INR 100 million) plus an education cess[11] of 3% on income-tax and surcharge would be levied on the above tax rates.

Further, in case of non-corporate taxpayers (being partnership firms), a surcharge of 12% (where total taxable income exceeds INR 10 million) plus an education cess of 3% on income-tax and surcharge would be levied. However, in case of non-corporate taxpayers (other than partnership firms), a surcharge of 10% (where total taxable income exceeds INR 5 million but not INR 10 million) or 15% (where total taxable income exceeds INR 10 million) plus an education cess of 3% on income-tax and surcharge would be levied.

The Finance Bill, 2018, proposes to replace the education cess of 3% with Health and Education Cess at the rate of 4%, effective 1 April 2018.

[11] Education cess is an additional levy of taxes on the base tax liability. The Government of India levies 2% of education cess and 1% of secondary and higher education cess (aggregating to 3% of total cess). The education cess is collected to ostensibly finance education and higher education.

Note 3: Exemption of tax on long-term capital gains arising from transfer of equity shares, acquired on or after 1 October 2004, will be available only if the acquisition was chargeable to STT. However, in order to protect the exemption for genuine cases, where the STT could not have been paid at the time of acquisition (e.g. Issuance of shares under preferential allotment, etc.), a list of transactions has been specified, which will be eligible for long-term capital gains tax exemption, on transfer of shares, even if no STT was paid at the time of its acquisition.

Note 4: The Finance Bill, 2018, proposes to levy tax on long-term capital gains arising on transfer of listed equity shares and units of equity oriented mutual funds exceeding INR 0.1 million at the rate of 10% (plus applicable surcharge and cess). The long-term capital gains would be computed without giving effect to the inflation indexation and the benefit of computation of capital gains in foreign currency. The amendment would be effective 1 April 2018.

6. Tax treaty re-negotiations: India's DTAA with Mauritius, Singapore and Cyprus

A significant share of investments by FPIs in India originate from Mauritius, Singapore and Cyprus. Until recently (i.e. up to 31 March 2017), investors from Mauritius, Singapore and Cyprus typically did not pay tax on capital gains arising on transfer of Indian securities on account of capital gains tax exemption in those treaties. However, in the last 20 months, the India-Mauritius, India-Singapore and India-Cyprus DTAA have been amended by the Government of India to provide that capital gains arising from transfer of shares of Indian companies acquired on or after 1 April 2017 shall be chargeable to tax in India. As a corollary, sale of shares of Indian companies which have been acquired up to 31 March 2017, shall continue to be exempt from Indian capital gains tax. Further, concessional tax rate has been provided for a transitional period of 2 years (i.e. from 1 April 1 2017 to 31 March 2019) in respect of the Mauritius and Singapore DTAA. In addition, the transfer of Indian securities other than shares of an Indian company (i.e. units of mutual funds, bonds, debentures, derivatives etc.) are not taxable in India. We have enclosed a table in Annex B which summarizes the taxability of capital gains arising to a non-resident investor under various tax treaties signed by India.

7. Measures to curb tax avoidance

a. General Anti-Avoidance Rules (GAAR)

With the stated intention of dealing with aggressive tax planning through the use of sophisticated structures and codifying the doctrine of 'substance over form', GAAR provisions were introduced in the Indian tax law and are effective from 1 April 2017.

GAAR provisions can be invoked by the Indian tax authorities to declare any arrangement entered into by a taxpayer as an 'impermissible avoidance arrangement'. GAAR provisions can also apply to any step in, or a part of, the arrangement as they are applicable to the arrangement. An arrangement is treated as an 'impermissible avoidance arrangement', if the main purpose thereof is to obtain a tax benefit. Where

GAAR provisions are invoked, benefits, if any, claimed by a taxpayer under a DTAA shall be denied.

Recognising the subjective nature of GAAR provisions and to provide some level of certainty to taxpayers, the Indian tax law has incorporated certain safeguards and also prescribed a process which the Indian tax authorities need to follow before invoking GAAR. The following are the key features of GAAR provisions:

- Investments made prior to 1 April 2017 are grandfathered;
- GAAR will not apply where the aggregate tax benefit to all parties to any arrangement in the relevant year does not exceed INR 30 million;
- GAAR will not apply to FPIs registered with the SEBI who do not avail of any DTAA benefits;
- GAAR will not apply to non-resident investors in relation to investments by way of an ODI or otherwise, directly or indirectly, in an FPI;
- To invoke GAAR, a two-stage approval process has been put in place – first by the Principal Commissioner of Income-tax/ Commissioner of Income-tax and second by the Approving Panel which is a three-member committee and chaired by a Judge of a High Court.

b. Multi-lateral instrument issued by the OECD under the BEPS initiative

The Base Erosion and Profit Shifting (BEPS) project of the OECD broadly looks to ensure that profits are taxed where economic activities generating the profits are performed and where value is created. The implementation of the BEPS Package will require changes to model tax conventions as well as to bilateral tax treaties based on those model conventions. The Multilateral Convention to Implement Tax Treaty Related Measures to prevent BEPS (MLI) seeks to modify bilateral tax treaties between two countries on principles of matching of their choices and will be applied alongside the existing tax treaties. On 7 June 2017, the first signing ceremony of the MLI was held in which 68 jurisdictions, including India, singed the MLI. At the date of 20 December 2017, 72 jurisdictions, including India, have signed the MLI. At present, it is expected that more than 1,100 tax treaties will be modified. The number of modified tax treaties is expected to increase continuously as many additional jurisdictions are expected to sign the MLI in due course. In accordance with the procedure laid down for countries to express their reservations and notifications, India has provided a provisional list of all its reservations on specific provisions of the MLI in respect of its 93 comprehensive tax treaties. Once the MLI is effective, it will have significant implications for Indian businesses with cross border operations and for foreign investors investing in India.

8. International Financial Services Centre and other tax incentives

a. International Financial Services Centre

The Government of India has established India's first International Financial Services Centre (IFSC) in Gujarat at GIFT City on 10 April 2015. A wide range of participants including banks, insurance companies, stock exchanges, clearing corporations and depositories, brokers, investment advisers, portfolio managers, alternate investment funds and mutual funds have been permitted to participate in GIFT IFSC.

Its core operations will include offshore banking; insurance, assurance and re-insurance, regional financial exchanges and back offices. The GIFT IFSC seeks to bring in India, those financial services and transactions which are currently being carried on outside India by overseas financial institutions.

The Government of India has provided a competitive tax regime for units located in IFSC which includes:

- A reduction in MAT rate from 18.5% to 9% for corporate tax payers;
- Exemption from DDT, STT, commodities transaction tax;
- Tax holiday for a period of 10 years (i.e. deduction of 100% of the income earned for first five years and 50% of the income earned for next five years);
- Exemption from tax on long-term capital gains even if the transaction is not subject to STT.
- Exemption from tax on transfer of capital assets being bonds, GDRs, rupee denominated bonds of an Indian company, derivatives, by a non-resident on a recognised stock exchange located in an IFSC and the consideration for which is payable in foreign currency (this is proposed by the Finance Bill, 2018 with effect from 1 April 2018);
- A reduction in Alternate Minimum tax rate from 18.5% to 9% for non-corporate taxpayers (this is proposed by the Finance Bill, 2018 with effect from 1 April 2018).

b. Special tax regime for offshore funds

With the stated intention of encouraging fund management activities in India, the Indian Government has progressively taken the following steps to provide a “safe harbour” regime for managing offshore funds from India:

- Introduced specific provisions in the Indian tax law to clarify that fund management activities carried out by a fund manager in India acting on behalf of the offshore fund will not constitute a business connection for the fund in India and that the fund will also not be treated as resident in India for tax purposes, subject to certain conditions.
- Pursuant to industry consultation, issued guidelines providing guidance on the application of the safe harbour regime including a mechanism for the fund to seek pre-approval from the Indian tax authorities on the applicability of the safe harbour regime and obtain certainty of the tax outcome.
- Progressively liberalized conditions in the safe harbour regime in the context of Category I and Category II FPIs for enabling foreign portfolio money to be managed from India.

F. Recommendations for Development of the Indian Equity Markets

PRIMARY MARKET

1. Issue of third party warrants

SEBI *vide* its consultation paper on '*Innovation in Securities Markets*' in 2003 had proposed to permit institutions like banks, financial institutions, mutual funds and insurance companies to issue third-party warrants for increasing vibrancy in the securities market. BSE, in 2014, also made recommendations to the Ministry of Finance (MOF) for permitting issuance of third party warrants. However, no steps have been taken in this regard.

We request SEBI to reconsider the proposal of permitting institutions like banks, financial institutions, mutual funds and insurance companies to issue third party warrants.

SECONDARY MARKET

1. Facilitate securities lending and borrowing

While introduced and operationalised in 2007 – 2008, the Securities Lending and Borrowing ("SLB") framework in India has seen limited participation. The lack of depth in this market has also made it unattractive for institutional investors. Pursuant to feedback received from the stock exchanges and other market participants and in consultation with the Secondary Market Advisory Committee, SEBI has now modified the framework for SLB, with the aim of injecting new life into the market.

While Approved Intermediaries ("AI") were permitted to decide the tenure of the contract (subject to a maximum period of 12 months), it is now clarified that they can introduce contracts of different tenures ranging from 1 day to 12 months based on the need of the market participants. While earlier, roll-over was available for a period of 3 months i.e. the original contract plus 2 rollover contracts, multiple rollovers of a contract are now permitted, provided the total duration of the contract (with rollovers) does not exceed 12 months from the date of the original contract.

In relation to participation, the limit of INR 50 crores for clearing members and institutional investor in relation to their open position has been done away with and these entities are subject to only a restriction of 10% of the market wide position limit.

SEBI has modified the details of treatment of corporate actions during the contract tenure. In case of corporate actions such as bonus, merger, amalgamation, open offer, etc., the contracts will now be foreclosed on the ex-date. It was also noted that in the event of Annual or Extraordinary General Meeting, AIs are mandatorily foreclosing the contracts. Based on representations by market participants that mandatory foreclosure may not be necessary as all lenders may not be interested in taking part in these meetings, SEBI has now decided that the AIs should provide facilities for contracts which will continue to be mandatorily foreclosed and those which will not be foreclosed.

While these changes may certainly contribute to the improvement of the market, it remains to be seen if they will have a significant impact. It may also be noted that many anticipated changes, such as increasing the number of eligible securities, easing norms to facilitate more institutional participation, especially by mutual funds and depositories, do not find a mention in the latest circular.

The current infrastructure is domestically oriented with market nuances which present challenges to FPIs. For example, further development on corporate events with protections for stock on loan together with greater loan duration flexibility with loan recall and early return accommodation would be welcomed. There is also some ambiguity on the tax treatment of manufactured payments and short sales which requires clarification. India is an expensive market for FPIs to operate in; a recent RBI circular reaffirmed that margin / collateral maintained by FPIs can only be in non-rebate INR cash which is inconsistent with local players who can post Government securities. We believe that these changes would create further opportunities for the SBL market in India to grow.

2. Algorithmic trading

a. Background

Technology has brought dramatic changes to financial markets as it has to virtually every industry. Algorithmic (algo) trading, the use of automation to execute transactions according to the needs and goals of investors, has been an important tool in the evolution of equity markets and most other financial markets. The benefits have been substantial by driving large decreases in transactions costs and enabling investors, both institutional and retail, to achieve portfolio objectives more efficiently and effectively, hence improving investment performance.

Clients of institutional investors assess the performance of their existing asset managers or those whom they consider hiring according to their ability to match or exceed the performance against market benchmarks. Minimizing execution costs by using algos is an essential means to do so in modern equity markets. Such “impact-driven” strategies evolved as investment managers sought to slice larger orders into smaller ones in order to spread the order over time, thus reducing the total impact cost of such orders.

b. Algo trading strategies

Algo trading can largely be categorized into *Execution strategies* and *Investment strategies.*

Execution strategies are algos designed to execute buy and sell investment decisions which have already been made. The most widely used impact-driven execution strategies include: Volume-Weighted Average Price (VWAP) and Time-Weighted Average Price (TWAP) orders, which aim to mirror benchmarks with low tracking error. Additional benchmark execution strategies include Percentage of Volume (POV), Implementation Shortfall (IS) and Target Close or Market on Close (MOC). Detailed descriptions of these strategies can be found in Annex C.

The strategies above require the algo to monitor real time market conditions and to submit or to amend orders consistent with the algo strategy. VWAPs, POVs, and some other algos not only track how much of an order has been filled, but whether the rate of fills is in line with the goal of the algo or not. CARs (Cancel-And-Replace) might be made to orders in the queue to increase or decrease the fill rate depending on the algo's moment-to-moment performance relative to the benchmark.

Investment strategies: include fundamental strategies, momentum strategies, event-driven or special situations-driven strategies, statistical/quantitative strategies as well as market making strategies. These are traditional investment strategies, but which today employ dynamic execution algos which change and adapt to market conditions. The execution strategies selected depend on the characteristics of the investment strategy, which determine how time sensitive or impact cost sensitive the execution algo is. The investment strategies employ execution strategies that the investor believes are best suited to the investment strategy. Some investment strategies, such as momentum strategies, are typically more time-sensitive, hence the selected execution strategy may be more aggressive and have more market impact. More detail on these investment strategies can be found in Appendix C.

c. High rates of Cancel-and-Replace (CARs)

Algos are preprogrammed to respond quickly to changes in market conditions. Execution strategies, per above, require high levels of CARs as they respond dynamically to market price movements. Also, investment strategies such as market making will have bids and offers which are frequently cancelled and replaced as market prices fluctuate since market makers have an obligation to stay in the market continuously. Additional sources of high levels of CARs include:

- Open/Closing Auctions -- The nature of the auction process means cancellations are often required following the auction. To minimize price impact while maximizing execution, algos may adjust price and volume participation in auctions based on indicative price and indicative cross volumes. Since the actual auction price and volume will differ from the indicative ones, cancels will be generated after the auction. Closing auctions are widely used by institutional investors to minimize tracking error, or undesired deviation from the benchmark. Limit orders in an auction may be more or less aggressive depending on the urgency of the order, which depends among other things on how much of the order has already been filled prior to the auction. For passive funds in particular, failure to complete an order by the end of the day risks significant tracking error because of the risk of overnight news creating a significant market move. Requests for client redemptions also typically need to be met by the end of the day. New funds need to be invested as soon as possible in order to minimize cash drag, the impact of uninvested cash on the performance of a portfolio. For these reasons the limit orders at auctions can be relatively aggressive, resulting in high levels of CARs.

- Impact of delays in data feeds -- The data feed from some exchanges reaches brokers and clients with a delay of several seconds. Consequently, limit orders sent by algos to the exchange may already be obsolete upon arrival, and will be cancelled and replaced as soon as updated data reaches the client's or broker's system. Obviously, this adds to the number and frequency of order cancellations.

d. SEBI industry consultation re algo trading and co-location

In August 2016, SEBI released a consultation paper on co-location and algorithmic trading "Strengthening of the Regulatory framework for Algorithmic Trading & Co-location", which looked to address concerns relating to market quality, market integrity and fairness. Proposals suggested by SEBI within this consultation paper were:

- Minimum order resting time
- Frequent intra-day batch auctions
- Random speed bumps
- Randomisation of orders
- Maximum order-to-trade ratio
- Separation of queues for co-lo and non co-lo orders
- Review of tick-by-tick data feed

ASIFMA believes it is crucial to recognize the degree to which the evolution of market structure and the accumulated benefits of technology have been enormously beneficial for investors, including retail investors. We strongly believe that we should collectively endeavor to retain the desirable features of modern market structure and make changes only in ways where the benefits clearly outweigh the costs and risks.

We are concerned that the above list of proposed major changes will adversely impact market quality and increase trading costs for all participants. The proposals as drafted would also impose significant costs on market participants in the form of infrastructure investments, software development, staff training, and revision of legal and compliance systems that will take significant time to implement. Of greater significance, we believe that they could unintentionally increase system risk due to added complexity while adversely affecting market participants' ability to manage market risk.

e. Algo testing requirements in India

The current regime for algo trading code under the Technology Change Circular, Testing and Processing, requires monthly mandatory testing of algos, including those that have already been tested. In order to meet the current monthly mandatory testing requirements, multinational firms need to have their global technology systems and trading desks around the world available for support purposes on Saturdays. This creates a considerable burden and expense, especially for the teams that are located outside of India. We believe that a modification of the requirement would satisfy prudential goals in the testing and maintenance of algos, whilst at the same time relieving the industry (exchanges as well as market participants) of significant resource commitments.

We suggest that SEBI, NSE and BSE consider modifying the requirements as per below:

- Firstly, the mandatory testing of algos that have already been successfully tested and in use be moved from monthly to quarterly. A testing environment should, however, still be provided on a monthly basis for new algos or those that have undergone material changes.

- Secondly, in order to make such quarterly tests effective, only one or two stocks should be designated for testing algo trading. This would help in creating volume in such designated stocks and enable effective checks of the algos' functioning.

- Thirdly, as a step forward, we would suggest that instead of mandating new mock algo testing on Saturdays, that the testing be made available in the exchange test market, which is available daily. While the testing may not take place in the production environment of the exchange, ample volumes in the test market will help ensure comprehensive testing.

- Further, rollback of algos from production after mock testing on Saturdays (whilst waiting for exchange approval) and then re-deploying them in production upon receipt of such approval introduces a risk of human error due to frequent changes in the implementation process, which can be reduced by introducing testing within the exchange's test environment.

Also, the current regulatory regime with respect to technology changes requires that any technology change relating to the trading system should be put through the testing, audit and exchange approval process as prescribed. However, many of our members have received verbal clarification that this is required only with respect to changes that are considered "material". We think it would benefit the industry, the exchanges, and SEBI if an FAQ could be drafted that would clarify that not all technology changes need go through the testing, audit and exchange approval process; rather, that only "material changes" would require such. We hope that such an FAQ could include certification requirements from the exchanges, procedures for certification by brokers, a list of risk controls, circumstances that would trigger repeated certification, applicable formats, guidelines and considerations to take when determining material changes.

f. In conclusion

Institutional investors use algorithmic tools, or "algos", for the great majority of their trading. The use of algos has played an important role in bringing greater efficiency to the challenges of executing orders for portfolios, and in the process contributed dramatically to a reduction in transaction costs and to an improvement in portfolio performance, benefitting investors and seekers of capital. Algos are used to slice orders into smaller child orders, spreading the order over a longer period to optimize the investor's goal given the constraints of time and market risk.

With regard to HFT, neither colocation nor low-latency are in themselves abusive. As discussed, low-latency strategies of many market participants have contributed to large reductions in transaction costs in financial markets, while benefits have accrued to investors, issuers, and the economy as a whole. ASIFMA believes that the optimal way to address abusive market practices is to identify such practices and create targeted regulations to control and stop them.

An experimental approach may be a prudent way to proceed. We think an initial surveillance phase to analyse and quantify current market conditions and activities in Indian equity markets in the context of any proposed solution contemplated by SEBI would be advisable. The implications and potential impacts of the solution could then be more thoroughly evaluated. Thereafter a pilot project could be launched to further evaluate the real-world impact of the solution and the responses of investors and other market participants and infrastructures. This would allow careful assessment of the full range of impacts of the solution on market participants and market quality. We would also urge that any adopted solutions following a consultation process be announced with sufficient notice and with all necessary technical information so that all market participants have sufficient time to make the necessary amendments to their infrastructure.

3. Block trading

cyril amarchand mangaldas
advocates & solicitors

Pursuant to recent changes in the regulatory framework on block trades, there are now two separate trading windows of 15 minutes each (in the morning and afternoon) for such trades instead of the single morning trading window of 35 minutes. The minimum order size has been revised to INR 10 crores from INR 5 crores, although, the framework with respect to range of the transaction price of a share (± 1% of the reference price), surveillance and risk containment measures for block deal trades will remain unchanged.

The new afternoon window operates between 02:05 pm IST to 2:20 pm IST and the reference price for these deals is the volume weighted average market price of the trades executed in the stock in the cash segment between 01:45 pm IST to 02:00 pm IST.

While SEBI's initiative to introduce reforms in the space is certainly commendable, one of the most commonly cited shortcomings of the earlier mechanism, was the narrow pricing restrictions. Unfortunately, this continues to be the case in the revised framework as well. Market participants including ASIFMA have provided feedback to SEBI in the past stating that a band of ± 2-3% to 5% would provide sufficient increase to facilitate higher trading volumes in the block window. Putting through trades on the floor of the exchange outside of the ± 1% band would also allow the transactions to assist with price discovery on the market and allows for some level of participation by the retail shareholders who put through simultaneous orders. An increased price band would also increase market efficiency and bring Indian standards in line with global practices. Restricting block trades increases market stress and volatility, encourages information leakage and discourages portfolio investors from participating in the Indian markets.

Managing costs of trading is critical for most large institutions and block trades are globally utilized by institutional investors for controlling such impact costs. This is especially relevant given the volumes available on overseas exchanges and the continuing export of capital that the Indian securities market is facing, due to these inefficiencies.

4. Extension of the trading hours

a. Background

The NSE and BSE are currently open for trading from 9am to 3:30pm, for both cash equities as well as for derivative products. The MCX is open for trading Indian commodities from 10am to 11:30pm. SEBI, which regulates both stock and commodity markets in India, has allowed equity exchanges to trade up to 5pm. The potential extension of trading hours in India has been widely reported by the media in 2017 and has become a contentious issue between stock exchanges and brokers. Whilst exchanges believe that the extension of trading hours may help them compete more effectively against similar products on offshore exchanges, brokers have expressed concerns that benefits would be marginal if any and most certainly outweighed by the costs required to support such extended trading hours. K Suresh, President of ANMI (Association of NSE Brokers), was quoted by *The Hindu BusinessLine (Nov 12, 2017)*: "The cost of trading would far exceed its benefits if trading hours are extended beyond the current limit."

b. Growing competition from offshore exchanges

The Nifty 50 index is NSE's benchmark stock market index for the Indian equity market, representing the weighted average of 50 Indian company stocks across multiple sectors. Nifty is owned and managed by India Index Services and Products (IISL), a wholly owned subsidiary of the NSE. The Nifty 50 index was launched in 1996 and has become the most actively traded product ecosystem (ETF's, futures, options) not only on domestic bourses in India, but also on offshore exchanges like the SGX, CME and on DGCX. The SGX in collaboration with the NSE has been particularly successful attracting investors to its Nifty 50 Index Futures, attracting international investors with its efficient and effective channel to gain offshore exposure to the Indian equity markets. The SGX Nifty 50 index futures has already exceeded the market share of its NSE counterpart in 2017, per table published by SEBI below:

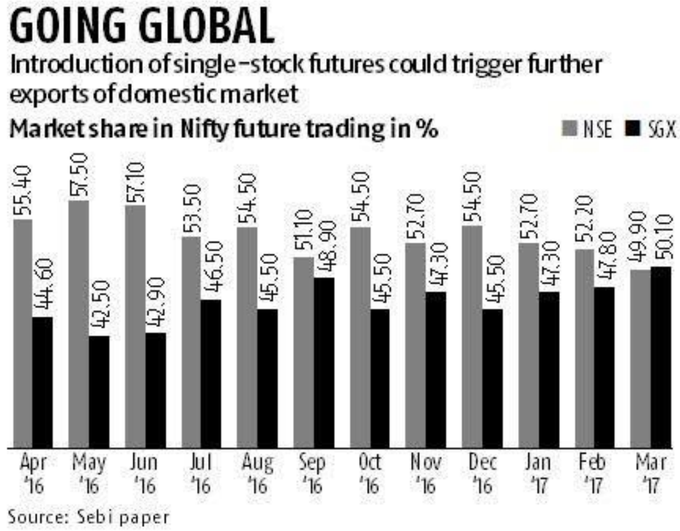


Figure 9: Market share in Nifty future trading in %
Source: SEBI

Per above, DGCX, on the heels of SGX's success and following SEBI's ban of P-Notes, is also about to launch its own Nifty 50 Index Futures product to expand beyond its current portfolio of offshore rupee and gold contracts. P-Notes had previously given foreign investors easy access to India markets but without the corresponding tax and regulatory hurdles. Post P-Note ban, even if foreign investors directly register as FPI's, current rules restrict many funds to invest only in CFTC approved futures, which prohibits them from trading single stock futures on the NSE. The CFTC takes into consideration several factors, including the efficiency of the settlement system, AML, KYC and overall futures liquidity before issuing a 'No Action' letter. Perhaps not a small consideration for the CFTC approved SGX to recently launch Indian single stock futures. A decade ago, P-Notes accounted for more than half of foreign flows into India's equity markets. There were open positions of more than 40k crore in equity derivatives before the P-Note ban in July 2017 (roughly equivalent to USD 6.2 billion).

c. Extending trading hours not the solution

Trading hours for the SGX Nifty 50 is from 9AM to 4:45AM SGT (6:30AM to 2:15AM IST) versus 9am to 3:30pm IST per above for the NSE/BSE. Unlike other exchanges where trading hours for derivatives may be different to the trading hours for cash equity, the two markets operate in tandem in India. Hence, considerations of extending trading hours for equity derivatives, both to match commodities trading hours (10am to 11:30pm per above) or to compete against offshore exchanges like the SGX or the DGCX have been applied to both cash equities as well as to listed derivatives, which is problematic for equities trading. Per Rajesh Baheti, ANMI Alternative President, in the same article of *The Hindu BusinessLine*: "Globally, no exchange trades cash equity round the clock, but only index derivatives."

d. Recommendation

Irrespective of potential reasons to consider matching trading hours on the derivatives side, it would be a mistake to do so for cash equities. Extending trading hours would not only require significantly higher investment in resources across the industry, there is no evidence to support that longer trading hours would result in higher trading volumes and higher revenues to the exchanges. In fact, most institutional investors have a set volume of trades they intend to execute on any given day. In today's world of algo trading and VWAP and TWAP strategies, to stretch out trading hours would only thin out trading volumes throughout the day. The low trading volumes may introduce higher levels of volatility into the market, or even worse, may encourage market manipulation. This may discourage the interest of institutional investors to raise investment activity given the higher risks. India should instead focus on the necessary regulatory and tax reforms to make its onshore capital markets more competitive to international institutional investors.

5. Reported Indian derivatives trading volumes are inflated

Inconsistent reporting methodology by the NSE/BSE versus other exchanges in the region inflates derivatives trading volumes and paints a misleading picture that Indian markets are excessively dominated by derivatives trading, as other markets calculate premium traded on options while the NSE/BSE do it based on notional.

As an illustration, there are two ways to show option volume:

Nifty 10600 Call @ 64 INR premium (nifty multiplier is 75)

- On premium: value will be 64 * 75
- On notional: value will be {10600+64) * 75

Hence, value on notional terms appears to be exaggerated (while only the premium value is getting traded). The below table 10 shows that the futures / cash ratio in India is in line with regional statistics.

2017 Futures/Cash Turnover (USD Million) Ratio			
Country	**Cash**	**Futures**	**Futures/Cash**
India	2,817	11,725	4.2
Hong Kong	11,294	25,942	2.3
Korea	4,730	23,969	5.1
Taiwan	3,384	8,221	2.4
Singapore	831	13,551	16.3

Numbers for countries except India do not include SSF turnover

Table 10: 2017 Futures/Cash Turnover (USD Million) Ratio as of 11 January 2018
Source: Bloomberg

Table 11 below highlights very different turnover figures when using option notional for calculation rather than option premium. The ratio comes down to ~4 when option premium is used, in line with the methodology of other exchanges in the region.

Turnover (USD Million) for India	
Cash	2,817
Index futures	2,662
Single stock futures	9,063

Total futures	11,725
Options notional	77,575
Options premium	420
Futures/Cash	4.16
Options notional/Cash	27.53
Futures + options notional/Cash	31.7
Options premium/Cash	0.15
Futures + options premium/Cash	4.31

Table 11: 2017 Futures/Cash Turnover (USD Million) Ratio: option notional vs option premium, as of 11 January 2018

Source: Bloomberg

FOREIGN ACCESS

1. FPI registration

a. Documentation

The Securities and Exchange Board of India (Foreign Portfolio Investors) Regulations, 2014 ("FPI Regulations") inter alia makes provisions for registration of an FPI. Any person wanting to register as an FPI is required to make an application to the designated depository participant (DDP) under the FPI Regulations. The application form is required to be accompanied by constitutional documents, authority documents, PAN etc.

Regulation 4 of the FPI Regulations prescribes the eligibility criteria against which the DDP evaluates whether the applicant should be granted the FPI license. The FPI Regulations along with the relevant circulars and a set of frequently asked questions ("FAQs") issued by SEBI in relation to FPIs stipulate documents that the DDP should review before granting registration / license to an FPI. The extant law requires a DDP to (a) obtain declarations; (b) additional documents from the applicant; and (c) conduct further searches to ensure that the applicant fulfils such eligibility criteria.

We note from the recent SEBI proposals (Consultation Paper on Easing of Access Norms for Investment by FPIs dated 28 June 2017 ("Consultation Paper for FPIs") and meeting of the minutes of SEBI board meeting held on 28 December 2017 that SEBI intends to ease access norms for FPIs in the Indian markets and we appreciate the steps taken by SEBI over the last years to facilitate FPI registration. We also look forward to the introduction of the common application form for registration, opening of bank and demat accounts and issue of PAN which was announced for FPIs as this is expected to significantly facilitate the registration process. However, the average time to registration for FPIs still takes a couple of months, which is posing a challenge for both the DDPs as well as the FPIs. The average registration time in India is also long compared to other jurisdictions in the region. The level of diligence required from a DDP vis-à-vis an FPI is substantial, which ultimately leads to an increased burden for the FPI applicants. The current complexity in the FPI regime and perceived barriers to entry are indeed causing buy-side firms to delay or cancel the launch of new funds in India, which might potentially attract substantial foreign investments into India.

The intention of SEBI to ease norms cannot be effectively implemented if the due diligence related compliances expected from the DDPs are not correspondingly reduced. With increased due diligence obligations on the DDP, the FPIs ultimately get impacted. An example of this is the additional declarations and documents expected to be obtained by the DDP from the FPI applicant to satisfy itself that the applicant is eligible to obtain the FPI license.

The principal that needs to be adopted and followed here should be *"What cannot be done directly should not be done indirectly"*. While the increased diligence may be needed for applicants intending to apply for FPI Category III license, Category I and II should be exempted from some of these diligence requirements. We note that the Consultation Paper for FPIs covers this proposal in relation to Category I and II FPIs. We strongly support this proposal and hope for the same to be implemented under the amendments to the FPI Regulations.

b. Offshore Derivative Instruments (ODIs) reporting format

FPIs are required to comply with certain reporting requirements in relation to ODIs issued by them in the offshore markets. This includes *inter alia*, providing details pertaining to the ODIs issued, underlying debt / equity / derivative against which the ODI is issued, values of the ODIs and underlying, UBO-related details, etc. Another requirement under certain reporting forms is to obtain a confirmation from the FPI that: "*We undertake that we/ our associates have not issued/ subscribed/ purchased/ sold any of the offshore derivative instruments directly to/ from Non Resident Indians/ Indian Residents*.."

Regulation 2(1)(j) of the FPI Regulations defines an ODI as: "*any instrument by whatever name called, which is* ***issued overseas by a foreign portfolio investor*** *against securities held by it that are listed or proposed to be listed on any recognized stock exchange in India or unlisted debt securities or securitized debt instruments, as its underlying.* (emphasis supplied.)" The definition of ODI under the FPI Regulations clearly state that ODIs can be issued only by an FPI. The <u>inclusion of associates</u> in the declarations to be provided by the FPI is not in consonance with the definition of ODIs.

For organizational structures functioning through multiple entities and/or in multiple jurisdictions, there may be requirements of maintaining Chinese walls between such entities despite of being under one group, either on account of internal group requirements or based on the legal or regulatory requirements imposed in the jurisdiction in which such entities operate.

Given this position, providing declarations on behalf of the associates has made the reporting requirements more onerous for the FPI and goes against the grain of ease of doing business in India. In line with this position, it is recommended that the reporting formats be revised to restrict any declarations / confirmations under such forms only to the FPI entity and entities under common control other than those which have Chinese wall requirements.

c. Restrictions on issuance of ODIs and impact on exporting of India's capital markets

Indian securities market being a part of a growing economy attracts foreign investors, where considerable number of such investors prefer investing in the Indian markets through an indirect route, i.e. ODIs. These investments typically carry two inherent advantages (i) no requirement of registering with SEBI as an FPI; and (b) applicability of minimal Know Your Customer (KYC) requirements (although the rules in India on identification of beneficial owners have been clarified recently). While these instruments are quite lucrative for foreign investors, they are believed to carry a major risk of money laundering.

As mentioned earlier, ODIs have been a focal point for the Indian Government and over the years, the route has seen a significant number of changes, in terms of streamlining the list of eligible counterparties, as well as enhanced compliance, KYC and reporting obligations being cast on the issuer FPIs themselves. Last year, by way of a circular dated 7 July 2017, SEBI imposed an additional restriction on FPIs stating that ODIs with derivatives as the underlying instrument can be issued only where the derivative positions have been taken for hedging equity shares held by the FPI, on a one-to-one basis. It was clarified that the phrase "*hedging of equity shares*" means taking a one-to-one position in only those derivatives that have the *same underlying* as the equity share.

All existing ODIs where the underlying derivatives positions are not for the purposes of hedging equity shares will have to be liquidated by the date of maturity or 31 December 2020, whichever is earlier. To issue new ODIs with derivatives as underlying, the compliance officer of the FPI has to issue a certificate (along with the monthly ODI reports) confirming that the derivatives position, on which the ODI is being issued, is only for hedging the equity shares held by it, on a one-to-one basis.

The circular has raised many issues. For instance, a one-to-one hedging strategy is over-simplified given that ODIs against derivatives have traditionally been used for long-short strategies, where a participant would go long on one stock and short on another in another sector. The SEBI directive also ignores strategies where an ODI is issued against derivatives to hedge an exposure to market indices, and not specific equity underlyers. The lack for references to ODI subscribers in the SEBI guidelines is in line with the SEBI approach that the FPI is the registered entity and hence remains accountable to the regulator for all its activities, including ODI issuances, but there is need for clarity in the guidance itself. SEBI has also been raising questions in relation to hedging done on a dynamic portfolio basis.

Clarity is needed from SEBI on the above issues as well as some practical issues. The stringent reporting and compliance mechanism imposed by SEBI and the evaluation criteria for ODI subscribers steadily increased over the past couple of years, especially after the report of the Special Investigation Team on Black Money in 2015. The opacity and anonymity that one historically associated with the overseas derivatives market does not exist any longer, given the requirements in relation to subscribers being regulated entities and stringent KYC and beneficial ownership checks.

These restrictions have also had an adverse impact on the ODI market in India. Not only are the foreign investors discouraged from investing in ODIs but also the FPIs are apprehensive about issuing ODIs. Despite all this, the Indian market still continues to look attractive to the foreign investors. However, with the direct investment market not appealing enough to these foreign investors and the indirect investment market (ODIs) being forced to shrink more by the day, the investors turn to the exchanges situated in other jurisdictions which are offering derivatives linked to Indian securities as these exchanges offer them nearly what they need with minimal restrictions. Examples include the Singapore Stock Exchange (SGX) which offers futures linked to Nifty 50 and the Dubai Gold and Commodity Exchange (DGCX) which offer single stock futures on Indian stocks and futures linked to S&P BSE SENSEX. These exchanges are further launching new products linked to Indian stocks and indices. For instance, SGX announced in January 2018 the introduction of single stock futures on Indian stocks. These offshore exchanges need to obtain a license from the Indian stock exchanges for offering such products directly linked to India stocks or indices such as Nifty futures. For instance, a license from India Index Services and Products Ltd. (IISL), a group company of NSE, is required for creating a product based on or linked to an IISL index. The permission granted to SGX for offering futures linked to Nifty 50 has also been sought from IISL.[12]Given their success, it is likely that they become more innovative in India-linked products and that other offshore exchanges will start showing interest in offering these products which is adversely impacting liquidity onshore in India.

As mentioned earlier, SGX India underlying index futures have indeed seen a gain in share of the average daily traded volumes from 22% to 39% over the last 5 years. SGX Index Futures form nearly 65% of open interest of Indian underlying Index futures.

Given the above, we would recommend SEBI to re-consider its decision of banning P-notes issued from naked derivatives positions in the Indian market. In the wake of this ban, and other tax treaty related amendments, there is high demand from investors to trade in Indian stocks on overseas platforms, where transaction costs, compliance requirements, and taxation are more favourable.

In addition, we believe that by restricting the ODI market, the regulator's concerns around money laundering might not necessarily be addressed and it goes against ease of doing business and the attempt of attracting foreign investors and foreign investment. Existing money laundering laws in India should be capable of dealing with such concerns. In fact, maybe the concern is not even there as indeed, in SEBI's own words: *"…till date, SEBI has not received any complaint or evidence with regard to money laundering through ODIs. Further no instance of money laundering was apparent from data gathered by SEBI from ODI issuers…"*[13]. Where there is no smoke, why are we crying fire?

2. Foreign accounts or foreign currency denominated Indian bank accounts

Currently, FPIs are required to maintain a rupee-denominated bank account in India and to make investments / receive sale proceeds only through such an account. Accordingly, every time an FPI wishes to purchase securities in India, they are required to bring foreign currency onshore, convert the foreign currency to Indian rupees, and then make investments. FPIs incur additional transaction / remittance costs and are exposed to currency risk through this process. The reduction of these risks and costs would make India a more attractive destination for FPIs.

[12] https://www.nseindia.com/supra_global/content/iisl/index_licensing.htm

[13] SEBI's letter dated 25th February 2016 to the Economic Times.

Investing through foreign accounts or foreign currency denominated Indian bank accounts will help FPIs reduce transaction costs, such as conversion cost, hedging cost, foreign currency exchange costs, etc. It could also help reduce the time lag for repatriating funds to and from India.

3. Lack of clarity on depository receipts

cyril amarchand mangaldas
advocates & solicitors

The depository receipt ("DR") regime in India is presently governed by the Depository Receipts Scheme, 2014 ("DR Scheme 2014"), notified by the Ministry of Finance, Government of India. The DR Scheme 2014 repealed the Foreign Currency Convertible Bonds and Ordinary Shares (Through Depositary Receipt Mechanism) Scheme, 1993 with respect of DRs. The DR Scheme 2014 was a result of long deliberations undertaken in the committee chaired by Mr. M.S. Sahoo which recommended various liberalisation measures recognising foreign investors' "home market bias" and the need for competitive neutrality between Indian and overseas capital markets.

While the DR Scheme 2014 was a step forward, there remain certain uncertainties including in relation to obligation of various intermediaries such as domestic custodians and depositories and taxation provision relating to DRs. As a result, DR issuances by Indian issuers have not gained the impetus that the DR Scheme 2014 intended to provide.

One understands from various sources that the Government of India is considering revision to the DR Scheme 2014. Broad concerns in the proposed revisions to the DR Scheme 2014 appear to be regarding the requirement of disclosing details of beneficial ownership of the DR. Additionally, if only regulated shareholders of listed companies are allowed to do a secondary DR offer, it will preclude individuals, employees, family trusts, HUFs, etc. (unregulated entities) from offering their shares for DR issuances. Similarly, restriction on the types of securities which can underlie DRs, will discourage market innovation and development of other instruments (such as units of trusts, mutual funds, derivatives, etc.) to be used as underlying securities for issuance of DRs.

The regulators may consider focusing on identifying roadblocks and providing clarity in the DR Scheme 2014 going forward so that Indian issuers have more flexibility in seeking access to foreign capital through the DR route. We request that the Indian Government implement operational guidelines and clarify any pending tax matters with respect to the issuance of unsponsored DRs by the DR banks, which was supported by the MS Sahoo report. Some investors cannot access Indian stocks because of restrictions in their investment mandates (for example, some pension funds that have a mandate for buying only dollar-denominated securities). Other investors still find the FPI registration process too cumbersome. Unsponsored DRs may provide a suitable alternative for these investors to accessing the domestic market directly.

OPERATIONAL

1. Account structure transparency versus operational efficiency

a. Background

SEBI had convened a meeting with both international buy-side and sell-side members of the industry in September 2017 to explore shifting from the current practice of post trade allocations instead to pre-trade allocations for cash equities, similar to the practice on the futures and options side.

SEBI was concerned about potential discretionary allocation of trades favoring some accounts over others, apparently owing to the discovery of such practices at some local mutual fund companies. However, any change in the rules would need to be consistent for both local and foreign market participants, which then moved SEBI to explore requiring trade allocations at the account level pre-trade rather than post. However, fund managers have a fiduciary duty to allocate on a pro-rata basis at the average price across all of their managed accounts. Therefore, requiring pre-trade allocations would actually impair their ability to satisfy such contractual obligations.

b. International perspective

The optimal account structure for any market provides investors with asset protection, low transaction costs and operational efficiency. Poor design of the account structure disproportionately impacts participation of cross-border investors, who are directing their investments in a global context and sensitive to differences in costs and expected returns. Policies that put regulatory transparency above all else typically come at the expense of considerable operational inefficiency. Hence, an appropriate balance between *regulatory transparency* on the one hand, and *operational efficiency* on the other, is essential.

Operational Efficiency: Most funds employ the services of a fund manager who makes investment decisions and execute trades on their behalf. These fund managers have a fiduciary duty to their clients for fair and equitable pricing. Global fund managers like Blackrock and State Street and Vanguard often invest in markets on behalf of hundreds of funds under their remit. Fund managers executing the same orders across multiple accounts need to allocate the same execution price across these accounts. This has led to the longstanding industry practice of placing block orders at the fund manager level, and then allocating the executions with the same average price across all underlying fund accounts in the interest of equity and fairness.

Regulatory Transparency: Regulatory authorities have multiple methods at their disposal to achieve the desired level of transparency (from the broker dealer level to the fund manager level down to the level of the ultimate beneficial owners / UBO). Each method has its merits. It is crucial to understand that the optimal method for achieving transparency depends on the regulator's objective in collecting the information. Is it for market surveillance, KYC, AML, or for tax compliance purposes? MiFID2 has now also raised the bar for increased transparency, requiring Legal Entity Identifiers (LEIs) for trading vs EU counterparties.

c. Recommendation

For market surveillance purposes, transparency at the fund account level can be provided, but on a post trade basis, after executions of the block trade at the fund manager level have been allocated equitably to the underlying accounts. Broker dealers currently already provide information on an as needed basis in response to such regulator requests. If transparency is required by regulators at the fund account level on a real time or pre-trade basis, the only way to achieve such would be to place orders directly in the name of each fund account with full transparency at the UBO level. The result would be different execution prices for the different fund accounts, since orders get filled at different times. The fund manager would then be forced to allocate different prices to its fund account clients, which would be in breach of its fiduciary duty for equitable pricing as defined in their offering memoranda.

But if the purpose of the regulator is to pre-empt and to stop market manipulation on a real-time basis as orders are being placed, there is no benefit to track such at the fund account level as it is the fund manager who is making the discretionary investment decisions on behalf of all of its underlying fund accounts. The below table provides a high-level summary of the considerations for balance as described above.

	Fund Manager (Order Placer)	Fund ID
Pre-Trade	• Fund managers execute orders across multiple sub accounts and need to allocate the same execution price equitably. • Fund managers make the discretionary investment decisions on behalf of underlying sub accounts. • For effective market surveillance, market issues should be raised with the entity responsible for execution, which is the Fund Manager.	• Can achieve such only by placing orders directly in the name of each fund account. • This would result in different execution prices for different accounts as orders would be filled at different times. Fund managers will not be able to satisfy their fiduciary duty to their clients for equitable pricing and best execution as defined in their offering memoranda. • If the regulator wants to pre-empt market manipulation real-time, there is no benefit to track on a fund ID basis. • Single fund ID orders can mean thousands of order messages for one trade causing excess load on the IT systems for the buy side, sell side and the exchange. This can lead to stability concerns and potentially outages as well as inflated costs for all. Additional messages also unduly increase latency.
Post-Trade	• Fund managers already disclose this information after the executions of block trades, so it's always available on a post-trade basis.	• To satisfy regulator needs, transparency at the fund account level can be provided for UBO purposes. • The manager can provide the regulator with the underlying account information after shares have been equitably allocated.

The Industry acknowledges the right and the need of regulators to have sufficient transparency for effective market surveillance. However, SEBI needs to balance such need with maintaining the operational effectiveness and efficiency of the market. In any case, if SEBI intends to propose pre-allocation of orders then a consultation paper should be published which should specify the mechanics of the proposed pre-allocation framework so that the market can provide its feedback on the SEBI proposal.

2. KYC/AML challenges

ASIFMA and its members fully support the end objective of the Central KYC Records Registry (CKYCR) as implementing it will ultimately be beneficial for clients and the Indian markets. The migration for FPIs from the KYC Registration Agency (KRA) regime to the CKYCR should be made smooth and that the risk-based approach which is currently in place under the KRAs should be maintained under the CKYCR system. We understand that SEBI supports a risk-based regime for FPIs and hope that RBI will likewise support this. We also hope that the risk-based approach will be reflected in the new common form that was announced during the 2017/2018 Budget and hope that the draft template will be subject to a market consultation.

We also recommend that KRAs would be able to bulk upload documents that are already available to avoid creating unnecessary burdens for the FPIs and their financial institutions and hope that MOF and SEBI will provide a clear roadmap and a phased approach for migrating FPIs to the CKYCR with a realistic deadline. Ideally, we suggest a three-year phase in period where FPIs are migrated from the KRA to the CKYCR system at the time of their renewal. It may be noted that documents required to comply with FATCA / CRS requirements are already collected separately and complied with through the custodians.

Lastly, we recommend that FPIs reclassifying from Category III to Category II should be permitted to request their custodian to remove information from the KRA which is not required for Category II registration.

3. List of restricted stocks for FPIs

The industry is currently facing issues in relation to the list of restricted stocks for FPIs in terms of sector restrictions. Challenges include the absence of a reliable list of companies and the lack of parameters for determination which is leading to substantial operational issues as well as divergent approaches across intermediaries. We therefore suggest that the primary obligation of ensuring that no foreign investment is made in companies in the prohibited sectors should lie with the Indian company (the issuer) and we suggest that the sector identification be made a part of the listing process. We suggest that each Indian issuer should be required to make this assessment, based on a set of clear parameters prescribed by SEBI and RBI and make the adequate disclosures in the offer documents. These RBI/SEBI guidelines should also clarify if there will be a *de minimis* test, whereby, activities in restricted sectors will be exempted from consideration in case they fall below a particular prescribed threshold in terms percentage of assets, income, turnover, and/ or profits etc. We suggest that these guidelines be inserted and retained in the regulations governing listing of Indian companies and disclosure requirements, including the Securities and Exchange Board of India (Listing Obligations and Disclosure Requirements) Regulations, 2015 and the disclosures to be made as a part of the Annual Report or as a part of an Annual Information Memorandum to be filed by the Indian company. These disclosures should not be limited to only identification of the sector, but also specify clearly if the Indian company is permitted to receive investment through the FPI route or not. This will be helpful in cases where companies are carrying out a diverse range of activities or are carrying out the activities falling under the prohibited list as an ancillary or incidental business.

Coupled with the initial assessment, should be the obligation of the Indian company to ensure that in case of any change in the business activities which results in the company falling in the prohibited sector, the Indian company promptly informs the relevant monitoring authority (such as the stock exchanges, depositories, etc.).

In line with the mechanism in place for monitoring FPI investment limits, the information on companies operating in prohibited sectors may also be collated and maintained by designated agency, such as the depositories or the stock exchanges. The Indian companies should have the obligation of ensuring that this agency is provided with the relevant information in a timely manner.

In addition, to make this process effective, we would request that the information provided by the Indian companies be made easily accessible online. Apart from mitigating the risks currently devolving on the custodians, this will also help FPIs determine investment strategies in advance. Accordingly, brokers will also be able to avoid the risks of trades getting devolved on them, where custodians do not confirm the client trades. In effect, this will lead to greater certainty in the market.

REGULATORY

1. Regulatory processes and the need for market consultations

In order to achieve the best reform possible, the application of a systematic cost-benefit analysis by India's government and regulators to any proposed new regulations would be highly beneficial to ensure that such regulations are targeted and that benefits will exceed costs. Additionally, increased regulatory transparency and consistency through a more open consultation process is called for with the participation of key market participants (including foreign participants) in order for securities market reforms to be successful as feedback from market participants is a key to the development of financial markets. The need for proper market consultations was recognized by MOF itself in the 2013 Handbook on adoption of governance enhancing and non-legislative elements of the draft Indian Financial Code (Section 4). Although the Handbook is only a guideline from the MOF, all regulators agreed to the resolutions therein.

Providing ample notification of new rules (including draft language) as well as allowing sufficient time for public comment and implementation lead time would also significantly improve the regulatory rule-making process and raise international investor confidence by reducing regulatory risk. Finally, if, after a consultation, significant changes are made to the proposed rule, a second round of consultations is appropriate to ensure the new changes do not result in unintended consequences for the market.

2. Consolidation of all disclosures under different regulations

We understand that the Securities and Exchange Board of India (Listing Obligations and Disclosure Requirements), 2015 consolidates all the disclosures required to be made by a company under the erstwhile listing agreement post listing its securities on a continuing basis. For ease of doing business, we recommend that the SEBI consolidates the other disclosures required to be made by a listed entity under Securities and Exchange Board of India (Prohibition of Insider Trading) Regulations, 2015 and Securities and Exchange Board of India (Substantial Acquisition of Shares and Takeovers) Regulations, 2011. This will enable the listed entities to have access to all the disclosures at one place and aid compliance by them.

TAXATION

1. Differentiated Securities Transaction Tax on FPIs in lieu of capital gains tax on listed securities

There exists a concessional income-tax framework for FPIs under the Indian tax law. However, the capital gains tax regime in India is complex compared to other global markets and there are various aspects of the tax system which, as outlined in this paper, make investing into India more onerous relative to other markets.

Globally, most countries do not impose capital gains tax on listed security transactions of foreign investors on their portfolio investments. In fact, no G20 country imposes capital gains tax on portfolio investment. Following is an illustrative list of countries that do not impose capital gains tax on portfolio investments in listed securities[14]:

Asia-Pacific	Australia, China[15], Hong Kong, Indonesia, Japan, South Korea, Malaysia, New Zealand, Philippines, Singapore, Taiwan
Europe	Austria, Belgium, Cyprus, Denmark, France, Finland, Greece, Germany, Hungary, Ireland, Italy, Luxembourg, Norway, Netherlands, Poland, Portugal, Russia, Spain, Switzerland, Sweden, Turkey, United Kingdom
America	Brazil, Canada, Chile, Colombia, Peru, United States

Table 12: Overview of countries not imposing capital gains taxes on portfolio investments
Source: EY

To raise revenue, many countries have adopted a transaction based tax, such as STT or stamp tax on listed securities transactions. These types of taxes are simpler and easier to administer. They achieve the twin goals of (i) raising revenue, and (ii) providing tax certainty and efficient functioning of the capital markets. Countries generally do not impose both transaction taxes and capital gains tax.

The Union Budget, 2018 announced by the Finance Minister of India on 1 February 2018 proposed to levy tax on long-term capital gains arising on transfer of listed equity shares, units of equity oriented mutual

[14] Various countries have maximum percentage holding thresholds for the purpose of capital gain tax exemption

[15] China - when they opened up their market to trade via the Hong - Kong Shanghai Stock Connect route in 2014, made the decision to not impose capital gain tax. The Stock Connect route is open to both institutional and retail investors.

fund and units of an Infrastructure Investment Trust or Real Estate Investment Trust, with effect from 1 April 2018 which hitherto was exempt from tax. Globally, India is one of the very few countries that imposes capital gains tax on foreign portfolio investments in listed securities, and even rarer amongst countries that impose both capital gains tax and STT.

Recommendation

The levy of long-term capital gains tax will increase the complexity of the tax system in India with respect to determining the period of holding, rate of tax for different investments (including the tax rates available under a tax treaty), etc. India may consider providing an exemption to FPIs from levy of short-term and long-term capital gains tax. In lieu of the exemption granted, a higher STT can be levied on FPIs. The above approach may be adopted after a comparative analysis of tax impact vis-à-vis competitive advantage. Hitherto, the regime of levying STT along with the exemption of long-term capital gains has provided clarity and certainty for taxation of FPIs. Thus, the long-term capital gains tax exemption which is proposed to be withdrawn should continue.

2. Multi-lateral instrument and GAAR

MLI was signed by 68 jurisdictions[16], including India on 7 June 2017 to implement tax treaty measures to prevent BEPS. Once the MLI comes into effect, the MLI will supersede the existing provisions of a DTAA. The MLI provides that countries signing the MLI will need to adhere to certain minimum standards.

Of the various minimum standards which are agreed as part of the BEPS final package, 'Prevention of Treaty Abuse' is one of the most important aspects of the BEPS concern which is contained in the MLI. One of the ways to address treaty abuse is to insert a Principal Purpose Test (PPT) Rule in DTAAs, wherein treaty benefits can be denied if it is reasonable to conclude, having regard to all relevant facts and circumstances, that obtaining that benefit was one of the principal purposes of any arrangement or transaction that resulted directly or indirectly in that benefit.

The PPT Rule has been adopted by 63 countries (including India) who were signatories to the MLI. Thus DTAAs entered into by India with the other countries who are signatory to the MLI will be modified to include the above measures. While various terms of the PPT Rule have been defined and examples have been illustrated, the explanation provided is very broad and subjective and does not offer conclusive guidance to taxpayers.

The PPT Rule and GAAR provisions are very similar in nature. While GAAR provisions are triggered where the main purpose of an arrangement is to obtain tax benefit, the PPT Rule is applicable where one of the principal purposes of an arrangement is to obtain benefits of a DTAA. Both GAAR and PPT Rule when applied will result in denial of DTAA benefits to a taxpayer.

In the event of a taxpayer being subject to the PPT Rule and the domestic GAAR provisions, it will create concerns for taxpayers since they may have to go through GAAR twice - first under the treaty and

[16] 72 jurisdictions as on December 20, 2017

thereafter under the domestic law. Further, while the Indian tax law provides safeguards and outlines the process on the way GAAR is to be applied, there is no guidance on how the PPT Rule will be applied by the Indian tax authorities.

Recommendation

Certainty and clarity in tax laws are two important elements for foreign investors investing into India. Hence, it is imperative that the following aspects should be considered by the Indian Government:

- Guidance along with examples be issued by the Government on how to interpret the PPT Rule - especially on what would constitute 'one of the principal purposes'.
- A taxpayer should not be subject to both - GAAR and PPT Rule. It should be clarified that only one of the two should be invoked.
- The way the PPT Rule is to be invoked is required to be specified. E.g. a minimum threshold should be provided for invoking the PPT Rule, seeking approvals of the relevant authorities, etc. Given that PPT and GAAR are similar in nature, the guidance provided in respect of GAAR should also be applicable for PPT.
- Arrangements/ transactions undertaken before the PPT Rule is made effective should be grandfathered.

3. Providing exemption from indirect transfer provisions to Category III FPIs

Certain clarifying amendments were made to the Indian tax law in connection with the indirect transfer provisions to provide that an asset or a capital asset being any share or interest in a company or entity registered or incorporated outside India shall be deemed to be situated in India, if the share or interest derives, directly or indirectly, its value substantially from assets located in India.

Taxation under the indirect transfer provisions is triggered if on a specified date, the value of gross assets in India:

- exceeds INR 100 million; and
- represents at least 50% of the value of all the assets owned by the company or entity.

Recently, to protect foreign investors from double taxation, an amendment was made to the Indian tax law which provides relief from indirect transfer provisions to investment made by a non-resident, directly or indirectly in a Category I or Category II FPI.

Non-residents making investments in Category I and Category II FPIs are exempted from indirect transfer provisions as the said FPIs are regulated overseas and broad based. However, a similar exemption is not granted to investors in Category III FPIs.

Though Category III FPIs may not be regulated in the foreign jurisdiction by the securities markets regulator or the banking regulator, Category III FPIs are subject to the SEBI FPI Regulations and are subject to, on their investments in India, the same conditions and restrictions that otherwise apply to Category I and II FPIs. They are in fact subject to a higher level of KYC by the SEBI Designated Depository Participants (DDPs).

Recommendation:
To protect foreign investors from double taxation and given that Category III FPIs are appropriately regulated by SEBI, exemption from indirect transfer provisions should also be provided to Category III FPIs on similar lines as Category I and Category II FPIs.

4. International Financial Services Centre units

With respect to taxation of income earned by a foreign investor from/ in the IFSC, the following concession should be provided:

- IFSCs should be regarded as a territory outside India from an income-tax perspective (similar to the treatment under the Indian exchange control regulations); and

Any income earned by the foreign investor through a transaction undertaken in the IFSC as well as from the IFSC should be exempted from income-tax in India.

5. Fund management activity in India

The Indian tax law prescribes a regime under which fund management of foreign funds can be undertaken in India, subject to certain conditions. These conditions are prescribed with the intention of ostensibly safeguarding the quality of the offshore funds that are sought to be managed from India in terms of the jurisdictions that they belong to, their ownership pattern, how they remunerate the fund manager, etc.

However, some of these conditions have proved to be onerous and challenging for fund managers of FPIs to relocate to India. Though similar conditions have been prescribed in other modern jurisdictions such as the UK and Australia, even in comparison to these jurisdictions, the number and nature/ extent of the conditions enumerated under Indian tax law have been onerous and impede the growth of a robust fund management industry in India.

Recommendation
The Government should rationalize some of the onerous conditions in consultation with the industry participants, to enable domestic management of offshore monies resulting in greater opportunities for Indian talent in the asset management sector as well as potentially higher taxes on the management fees earned.

6. Long-term capital gains tax exemption to be extended to Category III FPIs

The Indian tax law, grants exemption in respect of gains arising from transfer of a long-term capital asset, being, *inter-alia*, equity share of a listed company, if the transaction of sale is subject to levy of STT. The aforesaid exemption is available to all taxpayers including non-residents until 31 March 2018[17].

Long-term capital gains on equity shares acquired on or after 1 October 2004 shall be exempt from tax only when STT has been paid on purchase (as well as sale). However, to protect genuine transactions where STT could not be paid at the time of purchase of equity shares, it has been specified that the condition of payment of STT at the time of acquisition of equity shares shall not apply to all transaction other than specified transactions. Under the specified transactions, a specific carve out has been provided in respect of investments made by a QIB which, *inter-alia,* includes FPIs other than Category III FPIs registered with the SEBI.

Thus, where Category III FPI acquires equity shares otherwise than from a recognised stock exchange on which STT is not paid, long-term capital gain tax exemption cannot be claimed by such taxpayers even where the transaction of purchase is genuine in nature.

Recommendation

Given that Category III FPIs:

- fall under the SEBI FPI Regulations;
- are required to comply with all the provisions of SEBI FPI Regulations;
- route funds for investment strictly through formal banking channels; and
- form a major part of the total foreign capital being invested in the Indian capital markets,

they should be included in the specific carve-out as stated above which is currently, restricted only to Category I and Category II FPIs.

7. Taxation of GDRs issued against securities

With effect from 15 December 2014, Global Depository Receipts (GDRs) have to be issued under the Depository Receipts Scheme, 2014 (New scheme). The Erstwhile scheme for issuance of GDRs i.e. the Foreign Currency Convertible Bonds and Ordinary Shares Scheme, 1993 has been repealed. Key changes between the two schemes is tabulated below:

[17] Given that the Finance Bill, 2018 proposes to tax the long-term capital gains arising on *inter-alia*, listed equity shares and units of an equity oriented mutual fund exceeding INR 0.1 million with effect from 1 April 2018, the tax exemption available on long-term capital gains would now be available to the taxpayers till 31 March 2018.

Erstwhile scheme	New scheme
GDRs could be issued only by Indian listed companies	GDRs can be issued by both listed and unlisted Indian companies whether public or private
GDRs could be issued only against underlying shares	GDRs can be issued against underlying permissible securities such as shares, debt instruments etc.
Manner of taxation on conversion of GDRs into shares provided	Silent on the manner of taxation on conversion of GDRs into shares
Only sponsored GDRs were permitted to be issued	Both sponsored and unsponsored GDRs are permitted to be issued

Table 13: Comparison between erstwhile and new GDR Schemes
Source: EY

To restrict the availability of tax benefits to GDRs issued against shares of listed companies, the Indian tax law was amended as follows:

- Definition of the term GDR is amended to mean GDRs issued to investors (both resident and non-resident) against ordinary shares of a company listed in India;
- Tax implications for redemption of GDRs into shares of a listed company have been prescribed – the same is in line with the tax treatment provided in the Erstwhile Scheme.

Thus, currently there is no clarity regarding the manner of taxation of GDRs issued under the New Scheme in other cases (i.e. unlisted companies, GDRs issued against underlying securities not being ordinary shares).

Recommendation

Following amendments should be made to the Indian tax law to provide certainty regarding taxation of GDRs:

- Align the definition of the term GDR under the Indian tax law with the New Scheme.
- Alternatively, a specific regime for taxation of GDRs issued under the New Scheme (other than GDRs issued against ordinary shares of listed companies) should be introduced.
- Transfer by way of conversion of GDR (irrespective of the entity issuing the GDR and the underlying security against which the same has been issued) into the underlying security should not be regarded as a taxable transfer.

ANNEX A: Types of Access Products

There are two broad categories of access products.

Category 1: Access products where an exact hedge can be executed:

In respect of these access products, the underlying asset could be in the form of equity shares, derivatives (futures and options), etc. or a combination of both. The principle of such access products is that whether based on a single share/ derivative or a basket, there will always be underlying assets that the issuer can acquire to fully hedge its exposure on account of access product issuance. These products could, in turn, be either fully funded by the investor (i.e. paying full value on settlement) or leveraged, i.e. requires the investor to pay only a marginal amount in addition to collateral in the form of cash / securities. Where the access product is issued with leverage, the balance would be financed by the issuing entity for an interest fee, which is factored into the overall pricing of the access product that is issued by issuing-entity to the potential investor. The most common types of products are:

- Equity linked notes / Participatory Notes / Offshore Derivative Instruments ("ELNs"/"P-Notes"/"ODI's"): These are fully funded products. P-Notes typically have a single stock, an index, a stock basket as the Indian underlying asset. Upon purchase of a P-Note, investors are required to pay the entire purchase price upfront to the issuing entity. P-Notes are instruments issued to overseas investors who wish to invest in the stock market without registering themselves with local regulators.

- Swaps: Swaps are leveraged products where the investor places securities as collateral with the issuing entity in addition to margin payments. It provides a mechanism to raise leverage on P-Notes and stock baskets, where the access product has defined the underlying asset as securities in the cash segment and not the derivatives segment.

Other less commonly used products are warrants, synthetic futures and forwards and synthetic options.

Category 2: Access products incapable of an exact hedge

Category 2 access products are products where there is no single security, or combination of securities, in the capital markets that would provide a perfect hedge to the issuer. In such products, the issuing entity is required to purchase a combination of multiple securities (in the cash and / or derivatives segments) to achieve a hedge on the access product that has been issued.

Even in such situations there can never be a fully hedged position and the portfolio of hedges need to be continuously monitored and rebalanced to ensure that the issuing entity is hedged to the highest possible extent. The types of products are:

- Variance swaps: This is a leveraged product where the underlying asset is a hypothetical measure based on certain parameters of the level of volatility in the market. For example, an investor could purchase an access product stating that the volatility in the market is 2% based on certain mathematical calculations and following certain parameters. If the volatility is greater than 2% following the calculations, the investor may either have earned or lost money on the contract depending on whether they bet that the volatility would be higher or lower than 2%.

- OTC option / OTC swap / OTC forward: All these are similar to synthetic access products discussed above except these access products cannot be entirely hedged by purchasing the underlying asset stated in the access product agreement. They need to be hedged by a combination of purchases and regular portfolio churning to ensure that the risk to the issuing entity is at an acceptable level.

ANNEX B: Taxability of capital gains arising to non-resident investors under various DTAA's signed by India

Particulars	Capital gains on transfer of		Applicability of Limitation of Benefit Article
	Shares	Securities other than shares i.e. units of mutual funds, bonds, debentures, derivatives, etc.	
India- Mauritius DTAA			
Acquired before 1 April 2017	Exempt	Exempt	No
Acquired on or after 1 April 2017 and sold on or before 31 March 2019	50% of the domestic tax rate	Exempt	Yes
Acquired on or after 1 April 2019	Taxable	Exempt	No
India- Singapore DTAA			
Acquired before 1 April 2017	Exempt	Exempt	Yes
Acquired on or after 1 April 2017 and sold on or before 31 March 2019	50% of the domestic tax rate	Exempt	Yes
Acquired on or after 1 April 2019	Taxable	Exempt	No
India-Cyprus DTAA			
Acquired before 1 April 2017	Exempt	Exempt	No
Acquired on or after 1 April 2017	Taxable	Exempt	No
India-South Korea DTAA			
Acquired before 1 April 2017	Exempt	Exempt	No

Particulars	Capital gains on transfer of		Applicability of Limitation of Benefit Article
	Shares	Securities other than shares i.e. units of mutual funds, bonds, debentures, derivatives, etc.	
Acquired on or after 1 April 2017	Exempt[18]	Exempt	Yes
India-France	Exempt[19]	Exempt	No
India-Netherlands	Exempt[20]	Exempt	No

[18] If shareholding, directly or indirectly, is less than 5%.

[19] If shareholding is less than 10%.

[20] Capital gains from the transfer of shares of an Indian company constituting at least a 10% interest in the capital of that company, may be taxed in India if the alienation takes place to a resident of India. However, such gains shall remain taxable only in the Netherlands if the gains are realised in the course of a corporate organisation, reorganization, amalgamation, division or similar transaction, and the buyer or the seller owns at least 10% of the capital of the other.

ANNEX C: Algo trading

1. Algo Execution vs Investment Strategies

Algo trading can largely be categorized into *Execution strategies* and *Investment strategies.*

Execution strategies are algos designed to execute buy and sell investment decisions which have already been made, but to do so efficiently and effectively. The most widely used impact-driven execution strategies include: Volume-Weighted Average Price (VWAP) and Time-Weighted Average Price (TWAP) orders, which aim to mirror benchmarks with low tracking error. Additional benchmark execution strategies include Percentage of Volume (POV), Implementation Shortfall (IS) and Target Close or Market on Close (MOC), as illustrated in the table below:

Algo type	Behaviour	Considerations
Volume-Weighted Average Price ("VWAP"), Time-Weighted Average Price ("TWAP")	Provides a benchmark for trading. Paces execution to match the historical distribution of volume within your time horizon. TWAP will use a linear schedule.	Seeks completion within price and volume constraints and with low tracking error.
Percentage Of Volume ("POV")	Provides a benchmark for trading. Paces execution to match the given Target Participation passively in an attempt to save on spread.	
Implementation Shortfall ("IS")	Provides a benchmark for trading. Designed to minimise slippage from arrival price (the price in the market at the time the order is placed). Attempts to balance the risk of trading too aggressively and having market impact against trading too slowly and the price moving against you.	Seeks completion within price and volume constraints.
Target Close (also referred to as Mark on Close or "MOC")	Provides a benchmark for trading. Will attempt to trade your order in the closing session (where applicable) without having price impact. For larger orders, the algorithm will start trading before the auction. Limit market impact by adjusting the Aversion parameter.	May not complete if liquidity not available.

The strategies inherent in the algos described above require the algo to monitor real time market conditions and to submit or to amend orders consistent with the algo strategy. VWAPs, POVs, and some other algos not only track how much of an order has been filled, but whether the rate of fills is in line with the goal of the algo or not. Adjustments might be made to orders in the queue (Cancel-And-Replace or CARs) to increase or decrease the fill rate depending on the algo's moment-to-moment performance relative to the benchmark. CARs will be common for most strategies other than very small orders of a more urgent nature that can be filled quickly by crossing the spread. Institutional investors use such orders sparingly, however, because their impact costs are high.

Investment strategies are dynamic and change contingent on market conditions. The execution strategies selected depend on the characteristics of the investment strategy, which determine how time sensitive or impact cost sensitive the execution algo is. The investment strategies employ execution strategies that the investor believes are best suited to the investment strategy. Some investment strategies, such as momentum strategies, are typically more time-sensitive, hence the selected execution strategy may be more aggressive and have more market impact. Examples of some popular investment strategies include:

- *Fundamental strategies,* which seek to use some measure of fundamental value to make decisions to buy or sell. Common fundamental strategies include targeting stocks with low market prices relative to book value (P/B), to earnings (P/E), to dividends, etc. Some fundamental strategies compare the value of a stock to that of another stock, or to some other asset benchmark, such as a stock index. When a stock meets the criteria of the relevant strategy, the particular execution strategy could be any of the execution strategies described above. Because they tend to be sensitive to value, they typically seek to minimize execution costs, in particular impact costs, at the expense of speed of execution.

- *Momentum strategies* are a category of investment strategy typically based on technical analyses (looking at where the majority of the market is moving to be part of the direction). They seek to identify trading signals that historically indicate that a stock will continue along a trend. Momentum strategies are diverse partly because the time-frame used to identify trends varies widely, from very short periods to months or years. Momentum strategies will tend to employ more aggressive execution strategies because they are more time sensitive than fundamental strategies.

- *Event / special situations driven strategy,* where there is a material change in a company, including M&A activity

- *Statistical/quantitative investment strategies* use analytics to identify relationships among assets and/or patterns in price movements that have historically produced investment opportunities. These too are extremely varied and may also change as conditions change. For example, one form of such a strategy is pairs trading, where trades are done in two stocks based on their relative prices. Typically buys and sells in the pair are in opposite directions (buy stock A, sell stock B).

- *Market making is an investment strategy* that seeks to earn the spread between the bid and ask prices. That is, market makers seek to consistently buy at the bid price and sell at the offer price. By definition market making is passive. Hence market makers (and their algos) necessarily must cancel orders as the market fluctuates because bids and offers previously entered will have drifted from the current market price.

2. SEBI industry consultation re algo trading and co-location

In August 2016, SEBI released a consultation paper on co-location and algorithmic trading "Strengthening of the Regulatory framework for Algorithmic Trading & Co-location", which looked to address concerns relating to market quality, market integrity and fairness. Proposals suggested by SEBI within this consultation paper were:

- Minimum order resting time
- Frequent intra-day batch auctions
- Random speed bumps
- Randomisation of orders
- Maximum order-to-trade ratio
- Separation of queues for co-lo and non co-lo orders
- Review of tick-by-tick data feed

ASIFMA assessed the potential impact of the proposed regulatory measures and submitted the below industry response to SEBI:

Minimum Resting Time for Orders (MRTO)

- The required investment on the part of industry—exchanges, members, investors, vendors—to adapt systems for minimum resting time orders would be considerable. Its impact is also uncertain. The practical challenges to reprogram systems to manage synchronization of the trading lifecycle would be numerous. Specifically, timing cancellations or amendments to conform to minimum resting times, as well as of management of rejections and cancellation requests from clients that arrive during the resting period would require continuous calculation and re-calculation, adding extreme complexity to trading systems. We note that the U.K. government sponsored a comprehensive study of computerized trading in 2012, known as the "Foresight Project". It commented that the consensus of academic studies was that benefits of minimum resting orders were doubtful.
- Because investors' ability to cancel orders when the market is moving quickly would be constrained, volatility would likely increase, as would the risk of sudden price moves (or "flash

crashes”). This increase in risk would have the effect of widening bid-ask spreads and reducing liquidity, which could reduce stock values.

- For liquidity providers, there is a direct link between quotation and order amendment capabilities. Introducing a minimum resting time may discourage liquidity providers from tightening their quotes in the market in order to reduce their risk of having stale quotes. This could lead to the unintended consequence of increasing spreads and trading costs for all market participants.

- In our view it is questionable whether MRTO would reduce or eliminate manipulation and is quite possible that it would not achieve the desired effect. It may even create opportunities for new algos to take advantage of stale orders when the market is shifting. In short, we think MRTO is not advisable as it would bring uncertain benefits at the cost of considerable infrastructure investment, increased risk and reduced market quality.

Frequent Batch Auctions (FBA)

- At present, the Taiwan Stock Exchange (TWSE) conducts batch auctions every five seconds. Its experience demonstrates that Frequent Batch Auctions are feasible. Moreover, auction mechanisms have been widely employed in a wide range of markets throughout history in different countries; and as noted in the SEBI paper, India uses a call auction mechanism for illiquid stocks at the NSE, BSE, and MSEI. Most exchanges today use auctions for both market opens and closes.

- However, it is also true that the TWSE is the only major stock market in the world that uses frequent batch auctions throughout the trading day. Moreover, the TWSE has been steadily reducing the intervals between auctions. In July 2013 the TWSE shortened the interval between auctions from 20 seconds to 15; in February 2014 the interval was reduced again to 10 seconds; and in December 2014 it was further reduced to 5 seconds, where it remains at present. TWSE has also stated that its intention is to move to a continuous, order-driven market with a central limit order book, i.e., the model employed at virtually every other exchange today.

- One reason for the TWSE’s intention to transition to a continuous market format is the problem of interactions between the cash equity exchange and corresponding derivatives and futures markets. In particular, Taiwan’s equity warrant market trades continuously. An FBA market for equities necessarily would create arbitrage opportunities with underlying equity options (or warrants) as well as futures, especially if there are futures on individual stocks as is the case in India. While arbitrage generally is benign, even essential for fair and efficient markets, arbitrage between an FBA market and the underlying derivatives would be driven to some degree by the time lag between the two markets and arguably produce minimal efficiency gains. If FBA were adopted for cash equity markets, it may be advisable to synchronize the auctions with derivatives markets across multiple cash and derivatives exchanges and markets. This would pose considerable system and design challenges.

asifma

Growing Asia's Markets

UNIT 3603, TOWER 2

LIPPO CENTRE

89 QUEENSWAY

ADMIRALTY

HONG KONG

TEL +852 2531 6500

WWW.ASIFMA.ORG

Contributors:

cyril amarchand mangaldas advocates & solicitors

EY

Juris Corp advocates & solicitors

pwc