
FOREIGN PORTFOLIO INVESTMENT AND ITS IMPACT OF REGULATORY ARBITRAGE IN INDIAN CAPITAL MARKETS

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ABSTRACT

The research article will delve into the primary regulations governing Foreign Portfolio Investors in India, their impact of regulatory arbitrage in Indian Capital Markets while also examining the SEBI (Foreign Portfolio Investors) Regulations, 2019, SEBI Circulars and classification of FPIs, highlighting the investment avenues and investment limits. The article then slightly touches upon the Double Taxation Avoidance Agreement (DTAA) and the General Anti-Avoidance Rules (GAAR) in context of FPIs in India. The article then moved to case analysis of Adani-Hindenburg Research Report, exploring the opaque foreign funds and minimal disclosure requirements on beneficial ownership to evade regulatory scrutiny. The article further looks into the exploitation of Offshore Derivative Instruments (ODIs) and portfolio segregation to facilitate jurisdictional arbitrage and prevent market limitations. Lastly, the article evaluates SEBI's recent regulations on increased disclosure requirements and separate registrations for Offshore Derivative Instruments issuing Foreign Portfolio Investors. And the article concludes with key recommendations to be implemented for balancing both investor and country's interest, regulatory efficiency by filling gaps and India's long-term financial stability.

Keywords: Foreign Portfolio Investment; Securities and Exchange Board of India (SEBI); Double Taxation Avoidance Agreement (DTAA); Financial Action Task Force (FATF)

INTRODUCTION

Foreign Portfolio Investors (FPIs) contribute significantly to India's financial system by widening the capital markets for listed securities, derivatives, and bonds. Before diving deep into FPI, there's a need to discuss FDI and its differentiation from FPI to know the systematic difference. Significant differences between Foreign Direct Investment (FDI) and FPI. In FDI, the investor buys a majority stake, whereas in FPI, the investor purchases shares and bonds to engage with the market. FDI investors are considered active investors since they take part in business decisions, while FPI investors remain passive as they do not have controlling shares. FDI is a long-term investment because foreign companies often invest large amounts and establish businesses from scratch. On the other hand, FPI is considered short-term, as investors can withdraw their funds easily.

Regulatory arbitrage refers to the deliberate strategy of exploiting gaps in regulatory systems across various markets, allowing entities to avoid restrictive regulations.¹ Many bilateral investment treaties (BITs) and international investment agreements (IIAs) are made to protect investors and often favor them rather than the country where the investments are made. In the meantime, investors benefit through Double Taxation Avoidance Agreements (DTAAs), which India is a signatory to certain countries, which reduce charges on cross-border earnings through tax relief. On these transactions, regulatory arbitrage has occasionally resulted from these agreements, enabling investors to set up their funds in ways that minimize liabilities and disclosures.

The Securities and Exchange Board of India has tightened regulations² in response to these problems, especially for foreign investors who pose a high risk, which may lead to volatility in the market. ³This action is taken in reaction to allegations of stock manipulation made by Hindenburg Research ⁴against the Adani Group. In order to ensure compliance with India's

¹ Yash Sharan, *Rewriting the Rules: SEBI's Regulatory Crackdown on ODIs and the Quest for Market Integrity*, NLS Bus. L. Rev. (Jan. 13, 2025).

² Securities and Exchange Board of India, *Measures to Address Regulatory Arbitrage with Respect to Offshore Derivative Instruments (ODIs) and FPIs with Segregated Portfolios vis-à-vis FPIs*, SEBI/HO/AFD/AFD-POD-3/P/CIR/2024/176 (Dec. 17, 2024)

³ Chloe Cornish, *India Tightens Foreign Investor Rules After Hindenburg Report on Adani*, Regstreet L. Advisors (Nov. 1, 2023),

⁴ Hindenburg Research, *Adani Group: How The World's 3rd Richest Man Is Pulling The Largest Con In Corporate History* (Jan. 24, 2023).

minimum public float requirement, the updated regulations are aimed to curb foreign funds from hiding ownership details on claiming themselves as "public shareholders".

This research article will delve into the primary regulations governing Foreign Portfolio Investors in India, analyzing their impact of regulatory arbitrage in Indian Capital Markets through the case analysis of the Adani-Hindenburg controversy.

FPI- INDIA REGULATIONS

Being the securities market regulator, Security Exchange Board of India (SEBI) established Operational Guidelines and issued the SEBI (Foreign Portfolio Investors) Regulations 2019⁵ to govern and regulate foreign portfolio investors investing in India.

FPI – Categories

Government and government-related investors, such as entities controlled or at least 75% owned directly or indirectly by a government are included in the Category I FPI. This category also includes university and pension funds; appropriately regulated businesses like banks, insurance companies, portfolio managers, investment managers, asset management firms, broker dealers, advisors, and swap dealers; investors from Financial the Financial Action Task Force (FATF) member countries or any country specified by the central government.

FPI - Investment Avenues

India permits foreign investors to invest in both in equity and debt markets. Equity instruments includes both listed and shares yet to be listed. Investors can also trade exchangetraded derivatives on stock, commodity index, and currency. FPI can also invest in mutual fund units, Indian depositary receipts, and alternative investment structures such as Category

III Alternative Investment Funds, Infrastructure Investment Trusts (InvITs) and Real Estate Investment Trusts (REITs).

Permitted Debt Securities include treasury bills, non- convertible debentures (NCDs) including both listed and unlisted NCDs, municipal bonds, dated govt. securities, specified debt schemed

⁵ Securities and Exchange Board of India, Foreign Portfolio Investors Regulations, 2019 (as amended June 26, 2024),

mutual fund units, commercial papers, infra-debt funds, non-convertible preference shares and debt securities issued by Infrastructure Investment Trusts (InvITs) and Real Estate Investment Trusts (REITs).

Here, in the context of foreign portfolio investment, Foreign Portfolio Investors (FPIs) are categorized into two, that is, Category I FPI and Category II FPI. Government and government-related investors, such as entities controlled or at least 75% owned directly or indirectly by a government are included in the Category I FPI. This category also includes university and pension funds; appropriately regulated businesses like banks, insurance companies, portfolio managers, investment managers, asset management firms, broker dealers, advisors, and swap dealers; investors from Financial the Financial Action Task Force

(FATF) member countries or any country specified by the central government. Category II FPI includes individuals, corporate bodies, charitable organizations, family offices, and unregulated funds in the form of limited partnerships and trusts, as well as appropriately authorized entities investing on behalf of clients. Any appropriately regulated funds that doesn't fall under Category I FPI, will be included in Category II FPI.

Investment Limit On Individual Limit

The total equity ownership in an Indian company by an FPI and its group cannot exceed 10% of the company's fully diluted paid-up share capital. If multiple FPIs are connected by common ownership of over 50% or shared control, their investment limits will be combined. However, this provision does not apply to appropriately regulated public retail funds or those where a regulated public retail fund holds the majority stake on a look-through basis (examining the underlying entities to ascertain the ownership), nor does it apply to their regulated investment managers.

FIPs INDIA - TREATY

Foreign Portfolio Investors (FPIs) can claim tax benefits under the Double Taxation Avoidance Agreement (DTAA)⁶ of the country where they are residents, provided India has a DTAA treaty with that country. The DTAA provisions will have its own supremacy over

⁶ Foreign Portfolio Investors: Destination India (PwC India, Oct. 2024)

Indian tax laws, to the degree of beneficial provisions. Additionally, General Anti-Avoidance Rules (GAAR) are in place to prevent aggressive tax planning and will be applied if the primary objective of an arrangement is to gain a tax advantage while meeting specific conditions.

CASE ANALYSIS

The Adani Group was accused of corporate misgovernance, stock price manipulation, and exploiting the means of offshore shell corporations in a report (famously known as "Hindenburg Report")⁷ published in 2023 by the US based investment research firm

Hindenburg Research. The Adani Group was heavily invested in by Foreign Portfolio Investments (FPIs) and lacked the transparency of foreign funds, even though many of the accusations centered on accounting and business structuring. The report claimed that a small group of foreign portfolio investors (FPIs), including Cresta Fund, Albula Investment Fund, APMS Investment Fund, and Elara India Opportunities Fund, were serving as fronts for Adani insiders or entities involved in round-tripping Indian money through tax havens. The mentioned FPIs were registered in jurisdictions such as the British Virgin Islands, Cyprus, and Mauritius, which are notorious for their low standard and limited disclosure norms regarding beneficial ownership.

These funds were classified as Category II FPIs under SEBI's FPI Regulations, 2019, which has been discussed before. Due to this structural classification (as Cat I and Cat II) and their registration in FATF jurisdictions, they were not mandated to follow the most stringent disclosure requirements when it comes to beneficial ownership. This raised serious suspicions about the true identity and source of financing for these investments made in India, particularly because the above mentioned FPIs held substantial holdings in Adani companies. Their portfolio holdings are heavily concentrated in the Adani Group with no presence of diversification on holdings. By moving funds through Mauritius, these corporations could disguise themselves as "public shareholders" in India, escaping SEBI regulations on promoter holding limits and avoiding delisting requirements with respect to the guidelines.

Prior to the publication of the Hindenburg report, SEBI was under increasing pressure to investigate the beneficial ownership of these organizations, but it missed the many layers of

⁷ Hindenburg Research, Adani Group: How The World's 3rd Richest Man Is Pulling The Largest Con In Corporate History (Jan. 24, 2023).

fund arrangements that included shell firms and associated trusts as whistle blowing of "high leveraged Adani" criticism have been buzzing. Although SEBI FPI Regulations were structured to enhance transparency in FPI classifications, they did not entirely prevent regulatory arbitrage. Investors might still route funds with limited disclosure (through Category II FPIs), thereby allowing them to bypass investment limits by scattering their interests across multiple entities. As a vanguard, they also used Double Taxation Avoidance Agreements (DTAAs) with Cyprus or Mauritius to obtain tax exemptions/benefits as India is signatory to certain countries. By just following the minimal formal structural requirements, businesses could evade scrutiny under the General Anti-Avoidance Rules (GAAR), even if they did not meet the criteria. Coming to 2025, SEBI's recent regulatory changes⁸, including stricter guidelines for offshore derivative instrument (ODI) issuance that require complete disclosures on ultimate beneficial ownership (UBO) and detailed disclosure requirements for FPIs with large holdings in a single group, are an important step, where the foundation has been laid down by the former case. This regulation will move toward strengthening and improving market standard and control. These efforts aim to overcome current regulatory gaps/loopholes and bring India's financial legislation up to global standard set by the FATF.

CONCLUSION

As we saw throughout our article, it's evident that India's foreign portfolio investment (FPI) setting has shifted gradually over time to import capital from foreign investors and protect market integrity. On one side, problems exist, the SEBI Regulations set a strong basis by structuring investor categories and increasing transparency. With regard to beneficial ownership in the context of FPI, and the exploitation of offshore routes by some Category II FPIs, the Hindenburg-Adani case⁹ exposed the holes in our Indian regulatory ship. It emphasized that although laws/regulations exist on paper, effective implementation and structural flaws remain major issues.

To conclude, three key recommendations must be implemented to eliminate manipulative practice and regulatory scrutiny escapism, thereby protecting India's market reputation and

⁸ Securities and Exchange Board of India, Measures to Address Regulatory Arbitrage with Respect to Offshore Derivative Instruments (ODIs) and FPIs with Segregated Portfolios vis-à-vis FPIs, SEBI/HO/AFD/AFD-POD-3/P/CIR/2024/176 (Dec. 17, 2024)

⁹ Hindenburg Research, Adani Group: How The World's 3rd Richest Man Is Pulling The Largest Con In Corporate History (Jan. 24, 2023).

long-term financial stability.

First, adopting a stronger Ultimate Beneficial Ownership (UBO) verification system with no jurisdiction barrier. So that the look-through mechanisms are enforced efficiently by not restricting the SEBI's interference.

Second, Renegotiation of DTAAs with the countries like Mauritius and others to prevent misuse and exploitation of such treaties.

Third, seeking a multilateral cooperation beyond bilateral treaties, having a balanced favour towards both investors and countries where investments are made. Because market risk of volatility affects the general investors as a whole, having a contagion effect, thereby requiring global coordination and cooperation.

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