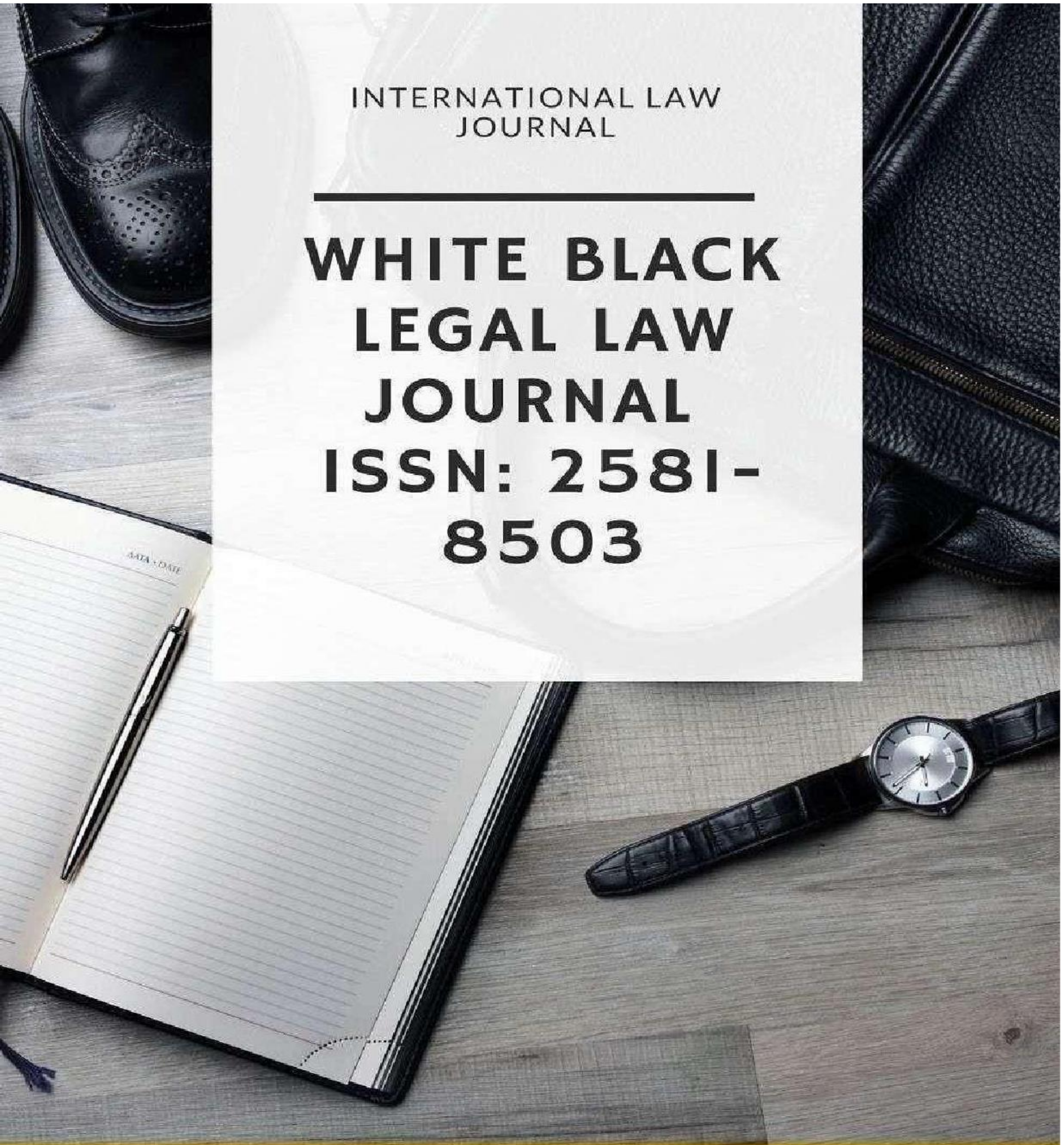

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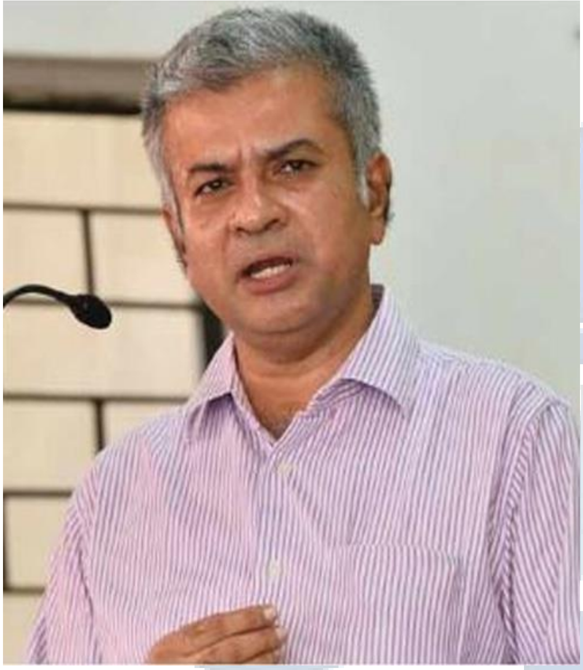

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With this thought, we hereby present to you

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AN OVERVIEW OF FOREIGN INSTITUTIONAL INVESTMENT (FII): N NIKHIL TEJA, BA.LLB, LLM, KARNATAKA STATE LAW UNIVERSITY.

AUTHORED BY - N NIKHIL TEJA

Introduction:

Foreign institutional investors are investment funds that are based outside of a country, and which invest in a country's financial markets. FIIs invest in hedge fund, insurance companies, pension funds, investments banks and mutual funds. FIIs act as one of the main sources of capital for developing nations which helps these investors earn higher return of investment on investing in developing nations as compared to developed nations. FIIs provide inexpensive capital and access to the global market, Institutional investors play a very crucial role in the financial markets of a country which motivates different kinds of businesses to grow themselves over and helps them to grow and enter new industries. In the recent years, the financial institutional investors have made a humongous investment in developing countries like India and China. India has attracted a lot of foreign institutional investments as it has been a fast-growing market and has been attractive destination for foreign investors who have got better return on investment than the mature developed nations. This acts as the motivation for foreign investors to make investment in developing nations. The NSE and BSE have provided a steep growth in the past years which has attracted foreign investments in the Indian market. This has made many domestic as well as foreign investor more optimistic about Indian market and has made easy and cheap access of capital which helps in the growth of the economy.

Keywords: FII's, Investors, Stock market, Domestic Investments.

OBJECTIVES OF THE STUDY:

1. To study the Overview of foreign institutional investors (FIIs) in emerging economies.
2. To study on regulatory authorities of FIIs on Indian stock markets.
3. To study comparative analysis on FII and Domestic Investments.
4. To recommend with key suggestions for minimizing existing risks and develop positive economic outcomes.

RESEARCH METHODOLOGY:

This research is a Doctrinal in nature. The present study is based on only secondary data is collected from various books and journals.

LITERATURE REVIEW:

- Kulwant Rai and N Bhanu Murthy (2006) the study determinants of Foreign Institutional Investment (FII) in India highlights the significance of understanding capital flow behavior post-liberalization. Utilizing monthly data spanning from January 1994 to November 2002, the study examines various factors influencing FIIs, focusing particularly on the roles of risk, return, and inflation. The researchers employed the Wholesale Price Index (WPI) for India and the Producer Price Index (PPI) for the United States, underscoring the importance of these economic indicators in shaping investor sentiment and FII trends during the specified period of economic liberalization in India.
- Prasanna, P. K. (2008) explored the role of Foreign Institutional Investors (FII) in India's capital markets, emphasizing their significant impact on capital availability and allocation. The study specifically investigated how FIIs' investment preferences are influenced by firm-specific factors such as capital structure, company performance, and stock characteristics. By analyzing these relationships, the paper aimed to provide insights into how FIIs contribute to market dynamics, liquidity, and the overall financial health of companies operating in India.
- Bansal and Pasricha (2009) This paper analysis the behavior of stock market to that of the after impact of opening market to FIIs. The change of market return and volatility after the entry of FIIs to Indian capital market is analyzed empirically and no significant change in the Indian stock market average returns is identified leading to a significant reduction in the volatility after India unlocked its stock market to foreign investors.
- Eun & Resnick (2002) This paper deregulation of financial markets and introduction of new financial avenues like internationally cross listed stocks, country funds and international mutual funds lead to rapid growth in international portfolio investments as investors could diversify their investment internationally with no additional cost.
- Dr. Jain Mamta, Ms. Meena Priyanka Laxmi, and Dr. Mathur T.N. (2012) This paper analysis the impact of FIIs on Indian stock market and economy through the correlation

between FII and BSE Sensex by coefficient of correlation test. The research attempts to understand the market behavior during the period of 2001 to 2010.

- Chauhan, Ajay and Malhotra, Amarjeet (2012) evaluated the effect of foreign institutional investment on the foreign exchange rate in India. Research determines that there exists unidirectional causality in the drive of FII investment in equity and the flow of exchange rate in India. However, no causal relation is found in case of FII debt investment on the exchange rate movement in India.

FOREIGN INSTITUTIONAL INVESTOR:

The Term Foreign Institutional Investor is defined by SEBI as an institution established or incorporated outside India which proposes to make investment in India in securities.

Provided that a domestic asset management company or domestic portfolio manager who manages funds raised or collected or brought from outside India for investment in India on behalf of a sub-account, shall be deemed to be a Foreign Institutional Investor. Foreign Investment refers to investments made by residents of a country in financial assets and production process of another country.

Entities covered by the term 'FII' include overseas pension funds, mutual funds, investment trust, asset management company, nominee company, bank, institutional portfolio manager, university funds, endowments, foundations, charitable trusts, charitable societies etc.

FIIs can invest their own funds as well as invest on behalf of their overseas clients registered as such with SEBI. These client accounts that the FII manages are known as 'sub-accounts'. The term is used most commonly in India to refer to outside companies investing in the financial markets of India. International institutional investors must register with Securities & Exchange Board of India (SEBI) to participate in the market. One of the major market regulations pertaining to FII involves placing limits on FII ownership in Indian companies. They actually evaluate the shares and deposits in a portfolio.

The SEBI (Foreign Institutional Investors) Regulations, 1995 govern the registration and operations of Foreign Institutional Investors (FIIs) in India. As per these regulations, any entity wishing to engage in buying, selling, or dealing in securities in India as an FII must obtain a certificate from the Securities and Exchange Board of India (SEBI). This certificate is necessary to ensure compliance with Indian securities laws and regulations.

The application for FII registration needs to be submitted in Form A, as prescribed under these regulations. This form includes details about the applicant's background, financial standing, proposed activities in India, and compliance with SEBI regulations. SEBI evaluates these applications based on various criteria, including the applicant's track record, financial stability, and adherence to regulatory norms before granting the FII registration certificate.

The application on **Form A** is required to be accompanied by the following documents:

- Copies of memorandum of association and articles of association of the FII.
- Brochures of the FII and its parent/group company.
- Copy of the investment management agreements or any other agreements authorizing the FII to invest on behalf of its sub-accounts/clients.
- Audited financial statements and annual reports for the last five years.
- Documents to support registration or regulation by a Securities Commission and Self-Regulatory Organization, or any other appropriate regulatory authority recognized by the SEBI.
- Copy of the Custodian Agreement with a custodian in India.

Importance of Foreign Institutional Investment (FII)

FIIs contribute to the foreign exchange inflow as the funds from multilateral finance institutions and FDI (Foreign direct investment) are insufficient.

- It lowers cost of capital, access to cheap global credit,
- It supplements domestic savings and investments,
- It leads to higher asset prices in the Indian market,
- And has also led to considerable amount of reforms in capital market and financial sector.

Modes of FIIs:

There are generally two ways to invest for FIIs.

1. **Equity Investment**: 100% investments could be in equity related instruments or up to 30% could be invested in debt instruments.

2. **100% Debt**: 100% investment has to be made in debt securities only.

Equity Investment Route: In case of Equity route the FIIs can invest in the following instruments:

- Securities in the primary and secondary market including shares which are unlisted, listed or to be listed on a recognized stock exchange in India,
- Units of schemes floated by the Unit Trust of India and other domestic mutual funds, whether listed or not,
- Warrants.

100% Debt Route: FIIs can invest in the following instruments under 100% Debt Route

- Debentures;
- Bonds;
- Dated government securities;
- Treasury Bills;
- Other Debt Market Instruments.

2: History and Evolution of FIIs:

The concept of institutional investors dates back to the early 20th century when investment firms and mutual funds began to pool capital to invest in various asset classes.

In the 1980s, many developing countries started liberalizing their economies, attracting foreign investment to boost their financial markets.

Before the **1990**s, India had a relatively closed economy with strict controls on foreign investments. Foreign investment was limited and regulated heavily.

Economic Reforms of 1991: In response to a severe balance of payments crisis, India embarked on major economic reforms in 1991, which included liberalizing its trade and investment policies. These reforms aimed to attract foreign capital to enhance economic growth, modernize industry, and integrate India into the global economy.

Regulatory Authorities of SEBI for FII Regulations, 1995:

To regulate and facilitate the entry of foreign institutional investors, the Securities and Exchange Board of India (SEBI) introduced the SEBI (Foreign Institutional Investors)

Regulations, 1995.

These regulations laid down the framework for the registration, operation, and monitoring of FIIs in India. The key objective was to attract long-term foreign investment while ensuring market stability and integrity. In 2014, SEBI introduced the Foreign Portfolio Investors (FPI) Regulations, which consolidated and replaced the earlier FII regulations. The FPI framework aimed to simplify the registration process and attract a wider range of foreign investors. The FPI regime categorized investors into different categories based on their risk profile and regulatory requirements. FIIs now fall under the broader FPI category, which also includes other types of institutional investors such as Qualified Foreign Investors (QFIs) and sub-accounts.

Role of Reserve Bank of India as a Regulatory Authority for FII

According to the regulations of reserve bank of India (RBI), the overall investment for foreign institutional investors is only 24% of the paid up capital of the Indian companies.

In the case of public sectors, the limit is 20% paid up capital but if the board and general bodies approve and passes a special resolution then investment can be raised up to 24% for the particular segment.

Prohibition of FII:

FIIs looking to invest in equity which is issued by an Assets reconstruction company and is not permitted under the SEBI rules, 1995. Foreign institutional investors are investing in any company which engaged in following activities:

Nidhi Company, Trading in Transferable Development Rights, Construction of Business, Real Estate Business, Agricultural Activities.

3: Foreign Institutional Investors vs. Domestic Investors

Foreign Institutional Investors:

FIIs are large investors from developed nations who invest significant funds in developing nations to seek better returns. Their investment can positively impact the domestic market, as the infusion of substantial capital can drive market growth, benefiting both foreign and domestic investors. FIIs may withdraw their investments in response to political instability, which can lead to market volatility.

Domestic Investors: Domestic investors are individuals or entities who invest their money within their own country. They typically analyze the market thoroughly before making investment decisions, aiming to maximize the returns on their savings.

The presence of FIIs in the market can create a favorable environment for domestic investors, as increased market activity and capital can lead to higher profits. Domestic investors are also sensitive to political stability. Political instability can cause domestic investors to hold back on investments, preferring to explore safer avenues for returns.

Impact on Indian Market: The Indian stock market has been an attractive destination for both FIIs and domestic investors, resulting in significant growth and returns. The arrival of FII funds has played a crucial role in advancing the Indian economy, improving the availability of capital for business ventures. Political stability is essential for maintaining consistent FII investment, which in turn supports market growth and economic stability. Both FIIs and domestic investors contribute to the robustness of the market, though their investment behaviors may differ based on external and internal economic conditions.

4: Fair-Weather Friends:

Foreign Institutional Investors (FIIs) are often referred to as "fair-weather friends" due to their tendency to enter and exit markets based on prevailing economic conditions and sentiments. When the global economy shows signs of instability or when there are unfavorable domestic developments, FIIs often withdraw their investments to mitigate risk, leading to market volatility. This phenomenon has earned them the reputation of being "fair-weather friends." During the global financial crisis of the COVID-19 pandemic, many FIIs pulled out their funds from Indian markets, contributing to substantial market declines.

Positive Contributions to Market Development:

Despite their sometimes-erratic behavior, FIIs bring numerous benefits to the markets they invest in. They inject significant capital, enhancing market liquidity and efficiency. Their involvement often leads to the adoption of better corporate governance practices and improved market infrastructure, driven by the high standards that FIIs typically demand. Moreover, the presence of FIIs can boost investor confidence and attract further investments, both foreign and domestic. Over the long term, these contributions help in the development and maturation of the financial markets, making them more robust and competitive on the global stage.

Mitigating Risks and Enhancing Stability:

To manage the risks associated with FII volatility, it is crucial for countries like India to implement strategies that enhance economic flexibility. This includes maintaining sound financial policies, diversifying the economy, and ensuring strong financial regulations. Attracting long-term institutional investors, such as pension funds and sovereign wealth funds, can provide more stable capital flows. Additionally, fostering a strong domestic investor base through financial literacy initiatives and investment incentives can help cushion the impact of FII outflows. Ensuring a stable and predictable policy environment is also essential in maintaining investor confidence and reducing the likelihood of sudden withdrawals by FIIs. Through these measures, the positive impact of FIIs can be maximized while mitigating the risks of their "fair-weather" tendencies.

Conclusion:

Foreign Institutional Investors (FIIs) have significantly influenced the financial markets and economies of various countries, particularly emerging markets like India. Their contributions to capital inflows, market development, and improved corporate governance have been invaluable in driving economic growth and modernization. However, the volatility associated with FII investments and the potential for market instability pose not able challenges.

Balancing the advantages and disadvantages of FIIs requires robust regulatory frameworks, effective risk management strategies, and a diversified investor base. By development a stable and transparent investment environment, countries can maximize the benefits of FII participation while minimizing potential downsides. Ultimately, the prudent management of FII investments can enhance economic resilience, promote sustainable growth, and integrate domestic markets more effectively with the global economy.

Recommendations;

Foreign Institutional Investors (FIIs) are influenced by several factors, including stock market returns, inflation rates, and existing risks. To attract more FII inflows, it is essential to comprehensively strengthen the determinants of their investments by considering both real economic and financial factors. Critical steps such as minimizing existing risks and stabilizing stock market volatility can significantly boost FII inflows, leading to positive economic outcomes.

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