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SEBI PUBLISHES HR KHAN COMMITTEE REPORT: KEY POINTS FOR CONSIDERATION BEFORE IT BECOMES THE LAW

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Introduction

On 24 March 2019, the Securities and Exchange Board of India (SEBI) released a report on redrafting the SEBI (Foreign Portfolio Investors) Regulations 2014 (FPI Regulations) by the Working Group constituted under the chairmanship of Harun R Khan (HR Khan Report), for public comments. The HR Khan Report tables recommendations to liberalize and simplify the foreign portfolio investment (FPI) regime from the perspective of (i) ease of registration; (ii) simplification of know your client (KYC) requirements; (iii) revision of investment limits and (iv) other miscellaneous liberalizations.

Highlights of HR Khan Report

We have analysed the key recommendations made in the HR Khan Report and their ramifications on foreign investment through the FPI route in India:

- **FPI Registration Process**

  - *Fast track on-boarding:* A fast track registration process with a simplified application form which exempts certain categories of applicants from, *inter-alia*, furnishing broad-based investor details, PCC/MCV declarations, Non-Resident Indian (NRI)/Overseas Citizen of India (OCI)/Resident Indian (RI) related information, intermediate shareholder details and information in respect of authorized signatories and senior management is proposed for select Category II FPIs. The exempted applicants are public retails funds from Financial Action Task Force (FATF) compliant jurisdictions, investment manager seeking registration on behalf of their funds, FPIs investing only in government securities or mutual fund units and FPIs investing only under voluntary retention route i.e. long-term commitment in debt securities are considered for fast track registration. The rationale is that such FPIs do not deal with high-risk investments and operate with more stable investment program.

  - *Treatment of pension funds*: Pension funds/superannuation funds/any other fund structures that provides retirement benefits, which are low risk entities, are proposed to be classified as Category I FPIs (low-risk FPIs), as opposed to the status quo of Category II FPIs (medium risk FPIs).

    Comment*: This signals a very positive message to the pension funds. From a risk weightage perspective, they would be brought down to the lowest risk* *category. Further they will also be viewed as long term investors alongside other sovereign investors. As a Category I FPI, their KYC requirements shall also come down significantly should this proposal be accepted by SEBI.*

- <u>*Review of broad-based criteria*</u>: The broad-based fund (BBF) criteria, which is a pre-condition to register as Category II FPI, is proposed to be amended as follows:

  - The extant law stipulates that applicants can obtain FPI license relying on the BBF status of their underlying funds or investors. This could be misused in structures where the BBF shareholder merely holds a token stake in the FPI vehicle. The HR Khan Report recommends an additional requirement that each underlying investor fund(s) which is a BBF, should have a minimum 25% stake singly or collectively in the FPI. This recommendation comes with a 3-year grandfathering provision for existing BBF Funds.

  - Insurance/re-insurance entities, either as applicant, or as majority stakeholder in an FPI vehicle, shall be deemed to be broad based fund provided such entities do not maintain segregated portfolio with one to one correlation with a single investor.

  - FPIs, which are majority owned, directly or indirectly, by investors eligible for registration as a Category I FPI viz. foreign central banks, foreign government agencies and international or multilateral agencies, shall be deemed broad based funds.

  - 180-day time frame is proposed for existing Category II FPIs to satisfy their BBF criteria. A 90-day period conditional registration is also proposed for unregulated entities, registering on basis of their investment manager being regulated, to meet BBF criteria.

  Comment*: The minimum stake of 25% could turn out to be a hindrance and may defeat the purpose for which this rule to rely upon underlying investors to satisfy BBF criteria was introduced. Underlying investors like superannuation funds, banks, etc. have to allocate investments in accordance with their internal policies and therefore their investment limits in FPIs are pre-determined. Such underlying BBF investors cannot therefore raise their stake in FPIs to 25%, if not allowed under their allocation policy. At the same time appreciating SEBI's concerns around such BBFs having meaningful interest in the applicant to qualify the applicant itself as BBF is also understandable. In light of this, Industry may represent SEBI to consider lowering the minimum ownership limit to lesser than 25% as proposed to say 10% or 15%.*

- <u>*Removal of opaque structure restriction*</u>: Acknowledging ring fencing as a regulatory requirement in many jurisdictions and given that all FPIs are mandated to provide beneficial owner (BO) details, the HR Khan Report has recommended the removal of restriction on opaque structures under the FPI Regulations. Consequently, HR Khan Report has also recommended the removal of the requirement to submit PCC/MCV declarations and undertaking at the time of application.

  Comment*: This signifies a major shift in the regulator's perception towards ring fencing and segregated portfolio structures not necessarily seeing them as inherently opaque. This should offer more flexibility to Multiple Investment Manager (MIM) structure or wealth platforms or multi-family offices to set up segregated liability structures for their clients in a cost optimal way.*

- *Removal of additional eligibility criteria for Category III FPIs*: Additional documentation required to be submitted by Category III FPI applicant to satisfy that the applicant is permitted to invest outside its country, is authorized by its memorandum and articles to invest on behalf of clients and has a sufficient track record, professionally competent, financially sound with good reputation of fairness and integrity are proposed to be omitted from the FPI Regulations.

- *Entities whose owners are eligible for FPI registration*: HR Khan report has recommended revision of criterion for certain category of investors. An entity wherein 75% control is held by an entity eligible for Category I registration shall be eligible for Category I registration in itself. Presently only foreign government agencies are permitted to hold a Category 1 registration. Entities where 100% control is held by entities eligible for Category II registration shall be eligible for Category II registration. Currently such entities are eligible only for a Category III registration. Further, banks belonging to countries where the central bank is not a member of the Bank of International Settlements should be eligible for FPI registration, as central banks signify low-risk and long-term investments. University funds/endowments should also be eligible for Category II registration.

➢ **KYC and Documentation Simplification**

- *Reliance on KYC by global custodian*: The HR Khan Report has recommended that since FPIs already undergo similar KYC processes in their home jurisdictions while setting up accounts with the global custodians, replication of the process at the time of registration with the Indian custodian (which is part of the same group) for non-PAN related documents is unnecessary. This is also in compliance with law, as Prevention of Money Laundering (Maintenance of Records) Rules 2005 ("PMLA Rules") allow for relaxation of norms when the reporting entity relies on a group entity and has already undergone similar processes in its own jurisdiction. Thus, a local custodian in India may rely on the KYC undertaken by its group entity which is regulated and from a FATF compliant country.

  Comment*: This is a big relief as many personal documents of directors or senior managing officials which serve as address proof need not be brought into India for KYC verification. It also saves the applicant from the burden of consularization/apostillisation of such documents. However, the proposal only extends to global custodians which have affiliates in India. We would have expected this benefit to be extended to all global custodians from FATF member countries as long as they have correspondent custodian relationships in India.*

- *Accepting FPI registration certificate as supporting document for PAN*: HR Khan Report has noted that the verification process of supporting documents for PAN application is more onerous than the certification requirements of KYC documents and has recommended that FPI registration certificate should be an adequate proof of identity and address for the purpose of PAN application.

- *Simplified PAN verification*: The HR Khan Report has recommended easing out the process for verification of PAN documents by accepting e-PAN for KYC compliance without the need to produce the PAN card or certifying it.

  Comment*: Both (ii) and (iii) will help towards reduction of time to operationalize the FPI account. Traditionally, PAN cards take up to 2-3 weeks to be issued and further one week for physical card verification by the custodian. The above steps will cut the time for application and verification of PAN and also save the applicant from furnishing identity proof and address* *proof documents again along with apostille hassles if the documents are foreign.*

- Harmonization of KYC for non-high-risk Category III FPI with Category II FPI: Given that utility bills or letters from bank are onerous to procure as address proof and a duly apostilled and notarized power of attorney is already accepted as address proof for Category II FPIs. HR Khan Report has recommended that the same benefit should to be extended to an FPI applicant from a non-high-risk jurisdiction seeking Category III registration. It is also proposed to harmonize KYC requirements for regulated Category III FPIs from non-high-risk jurisdictions with that of Category II FPIs.

  Comment*: Many regulated global funds launch niche India focused strategies with few investors to test the viability of their investment program in Indian markets. Such funds settle for onerous Category III FPI license as they are not broad based. The above recommendation will particularly ease out the application process for such funds as they will not be required to undertake KYC as onerous as for Category III FPIs.*

- **Investment Limits**

  - Elevate investment limit to sectoral cap: The HR Khan Report has proposed to remove the 24% ceiling on paid-up share capital imposed on all FPIs and equate the aggregate FPI investment limit to the sectoral cap of the investee company in accordance with the Foreign Direct Investment (FDI) Policy. Further, the concerned investee company has the option to reduce this aggregate FPI limit below the sectoral cap by way of board resolution.

    Comment*: This aligns with the government's intention to extend uniform treatment to all types of foreign investors. FPIs will not have to wait for the shareholder body of the company to raise the aggregate FPI limit up to sectoral cap. This gives FPIs an increased headroom to plan their investments. The increase in quantum of FPI investments should also consequently add India's weightage in the emerging market benchmark indices maintained by MSCI.*

  - Separate investment limit for Security Receipts: Recognizing FPIs as the source of much needed additional capital for alleviating the rising stressed assets situation in India, HR Khan Report has proposed that SEBI, in consultation with RBI, should consider feasibility of a separate limit for investment by FPIs in security receipts (SRs) which shall be outside the corporate debt investment ceiling.

    Comment*: Stressed assets are special situation investments, the ticket size of which are subject to market opportunities. Most FPIs were therefore unable to allocate investment room for distressed assets in accordance with debt investment limits prescribed by the RBI. The above recommendation takes care of this dilemma. To the extent investments in SRs are carved out from the overall cap for corporate bonds, FPI investment in non-SR instruments may also stand to gain from the separate headroom so created.*

  - Strengthening of clubbing rules: Where the 10% limit is breached by FPI entities pertaining to an investor group, HR Khan Report has recommended that either the investment of all investor group entities should be classified as FDI or appropriate divestment by the concerned investor group entity is made within 5 trading days to bring it below 10%.

    Comment*: The proposal is logical and seeks to align the FPI Regulations with FEMA provisions, but it also creates some ambiguities as to how this transition* *will be given effect to. For e.g., if an investor group were already holding in excess of 10% in a company, would this preclude an FPI (from the same investor group) from purchasing any further shares on the market in such company? In our view, the classification should be for the investment and not for the investor who should be allowed to execute trades in a manner as its status allows it to do and also continue to enjoy any benefits that are attached to its status as an entity.*

- *Clarification on 'to be listed' shares*: HR Khan Report has recommended that FPIs should be permitted to invest in 'to be listed' shares only where such shares are being offered under an IPO by the unlisted issuer or where an existing shareholder makes an offer for sale of such 'to be listed' shares to the public under rules framed by SEBI.

➢ Miscellaneous

- *Harmonization between FPI and FDI*: HR Khan Report has recommended that risk based KYC norms laid down by SEBI and RBI for FPIs should be extended to such FPIs for opening a separate securities account for holding FDI investments. Further it is proposed that FPIs be able to use cash balances in FPI account to fund investments under FDI route provided both the accounts belong to the same entity with same PAN. However, the HR Khan Report noted that these measures should be implemented only after ensuring adequate safeguards/control are in place to mitigate the same being used as a speculative measure.

- *Re-classification from FPI to FDI*: The re-classification of FPI investment in breach of 10% limit to FDI is in contradiction with the FDI Policy which permits FDI purchase of securities on stock exchange only where the investor has already acquired control. HR Khan Report has proposed operating guidelines to provide framework for FPIs to migrate to FDI regime in a transparent manner, most notably being a declaration to be furnished to the DDP to reclassify itself as a strategic FDI investor and all FDI norms becoming effective from the date of such declaration. Further it has recommended that where 10% limit is breached by FPI investor group on aggregate basis then such investor group should be permitted to hold its investment in the Indian issuer either as FDI or FPI but not both.

- *Alignment with AIF route*: The current FPI investment limit of 25% in the corpus of a Category III AIF has been recommended to be made applicable cumulatively on all FPIs pertaining to an investor group. FPIs can avoid their investment being reckoned towards sectoral cap by investing through an AIF whose sponsor and investment manager is Indian 'owned' and 'controlled'. The HR Khan Report has recommended that FPI investment in AIFs should be regarded as foreign investment provided the overall investment by FPI is more than 50%. Further the HR Khan Report has noted that Category III FPIs may invest in an AIF to bypass restriction on their 'Qualified Buyer' status and has proposed parity between FPI and AIF in terms of eligibility requirements for qualified buyer status which is pre-requisite to purchase security receipts.

  ***Comment**: It is vague whether the proposed caps would apply only for investment by FPIs in Category III AIFs or for all categories of AIFs. To the extent this cap was to apply to other categories of AIFs, we expect this to potentially create some challenges for some of the distressed assets platforms which use FPI route to participate in SRs but also use AIFs for equity and debt investments.*

- *Legal Entity Identifier (LEI) code*: HR Khan Report has recommended that all FPI and ODI subscribers should compulsorily obtain Lender Entity Identifier

Code which can be used by SEBI to monitor compliance with clubbing requirements, amongst others.

- *International Financial Service Centre (IFSC) GIFT City related*: Enabling changes were recommended to facilitate set-up of FPIs in GIFT city, chief amongst them being incorporation of such FPI in an IFSC to be a deemed satisfaction of jurisdiction criteria under Regulation 4, subject to compliance with other eligibility conditions under FPI regulations at the level of both FPI entity and its beneficial owners. Further funds floated by investment managers to SEBI licensed intermediaries i.e. mutual funds, AIFs and PMS shall be deemed appropriately regulated for the purpose of FPI Regulations.

- *Off-market transfers*: HR Khan Report has recommended that FPIs should be permitted to make off-market transfers to divest their holdings in shares which are either unlisted or suspended or illiquid on the stock exchange.

- *Offshore Derivative Instruments (ODI) framework*: The HR Khan Report clarified that ODIs with derivatives as underlying (which FPIs are proscribed to issue) shall mean ODIs hedged directly or indirectly on a one on one basis or portfolio basis in derivatives listed in India. Consequently, the ODI monthly statement provided to SEBI should include complete information on ODIs hedged on portfolio basis and one to one hedge.

Conclusion- Some Missed Opportunities

The HR Khan Report and the recommendations go a long way in easing and streamlining the process of application, KYC as also alignment with the FDI route. Some of the other crucial issues which remain unaddressed are: *First,* the suggestion to remove the aggregate NRI/OCI/RI investment limit of 50% in an FPI has not been considered. Though, the committee has recommended merger of FPI route and Portfolio Investment Scheme ("PIS") route which could be a potential solution here, exempting broad based funds registering as Cat II FPIs from the aggregate cap of 50% for NRIs/OCIs may be considered. *Secondly*, there is increased participation by exchange traded funds (ETF) under the FPI route. Such ETFs are listed offerings and therefore have a continuously changing investor base. It is practically impossible for such ETFs to ascertain their BOs based on controlling ownership interest as prescribed under the PMLA Rules. The exemption under PMLA Rules from the 'look through principle' to determine BO does not cover ETFs that are foreign entities. A specific notification exempting listed companies incorporated outside India under the laws of its jurisdiction is desirable.

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