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NRIS: NOT REALLY FOR INDIANS? SEBI TIGHTENS FPI NORMS

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The Securities and Exchange Board of India (SEBI) *vide* two circulars dated 10 April 2018 introduced certain changes in the Know Your Clients (KYC) requirements for Foreign Portfolio Investors (FPI) and clarified its stance with respect to clubbing of investment limits of foreign Government or their related entities. The salient features of the revised KYC requirements for FPIs and clubbing of the investments by foreign Governments or their related entities has been analysed in Part I and Part II of this article, respectively.

PART I: BENEFICIAL OWNERS OF FPIs & KYC REQUIREMENTS FOR FPIs

On 10 April 2018, the SEBI, *vide* a circular titled 'Know Your Client Requirements for Foreign Portfolio Investors (FPIs)' numbered SEBI Circular No. CIR/IMD/FPIC/CIR/P/2018/64 (FPI Circular 1) crystallized the concept of identification and verification of Beneficial Owner of an FPI (BO) and issued certain clarifications with regard to the restrictions placed upon Resident and Non-Resident Indians to be BOs of FPIs, apart from introducing certain other changes with respect to the KYC review of FPIs.

Identification and Reporting of Beneficial Owners

As per the FPI Circular 1, a BO is the natural person who ultimately owns or controls the FPI, in accordance with Rule 9 of the Prevention of Money-laundering (Maintenance of Records) Rules, 2005 (PML Rules). Thus, the concept of identifying the BO based on controlling ownership interest and control basis has been retained.

On the basis of controlling ownership interest, in case of a company, the BO is identified as per the materiality threshold of 25%, and in case of other entities such as a partnership firm or trust, the threshold stands at 15%. In certain "high risk jurisdictions" (as previously identified by the SEBI Master Circular on AML/CFT dated 31 December 2010), a lowered materiality threshold of 10% is applicable. The aforesaid thresholds are to be applied first at the level of FPI and the look through principle has to be applied to identify the beneficial owner of the material shareholder/ owner entity, i.e., the Ultimate Beneficial Owner (UBO).

In the event that using the materiality threshold, the material shareholder/ owner entity cannot be identified, for controlling ownership interest basis and control basis, the senior managing official of the FPI is deemed to be the BO. The FPI Circular 1 further states that in cases where companies or trusts are represented by service providers such as lawyers or accountants, the obligation is cast upon the FPI to provide information of the real or

effective owners of such entities. Moreover, the service provider is also to specify if the BO has been identified on a control basis, through means like voting rights, agreements, etc.

It is further clarified by the FPI Circular 1 that the BO should not be a nominee of another person or be a person mentioned in the United Nations Security Council's Sanction List as notified from time to time, or be from a Financial Action Task Force (FATF) jurisdiction.

Lastly, the FPI Circular 1 provides that the Category II & III FPIs are to provide a list of their BOs in the format as prescribed under the FPI Circular 1, while certifying that there exists no other BOs apart from the ones mentioned in the list. This obligation must be satisfied within six months from the date of the FPI Circular 1, i.e., 10 April 2018.

Restrictions on Indians / Non-resident Indians as BO of FPIs

The FPI Circular 1 has clarified that Resident Indians cannot be a BO of an FPI.

As regards Non-Resident Indians (NRIs)/Overseas Citizen of India (OCIs), for Category II as well as Category III FPIs, they shall continue to be permitted to invest in the FPIs. For Category III FPIs, the restriction on a company making investments as an FPI where the majority stake is held by NRIs remains unchanged, but the FPI Circular 1 categorically states that NRIs/OCIs cannot be the BO of the FPIs. However, an FPI promoted by NRI/OCI is permitted, if it is a Category II investment manager of the investing FPI, and is a non-investing entity.

The FPI Circular 1 prescribes a six-month time period from the date of its issuance, for FPIs to change their structure or close their existing position in the Indian securities market, to have it conform with the changes as brought about by the FPI Circular 1.

Restriction on issuance of Bearer shares

FPIs or BOs as identified on the basis provided for in the FPI Circular 1, are not permitted to issue bearer shares, even in the case that the home jurisdiction regulations permit them to do so. Compliance with the aforesaid restriction must be ensured within six-months from the date of issuance of the FPI Circular 1.

KYC review and documentation

As previously stated in the SEBI Circular on Know Your Client Requirements for Eligible Foreign Investors dated 12 September 2013 (SEBI 2013 Circular), the foreign investors are subject to KYC review as when there is any material change in the material information or disclosure.

As per the FPI Circular 1, there must now be a comprehensive KYC review of FPIs on a periodical basis as per risk categorization of the FPIs, i.e., on yearly basis in case of high risk clients and for all other clients, every three years, preferably at the time of FPI Registration.

The SEBI 2013 Circular had exempted FPIs from furnishing certain documents for KYC review. In respect of the exempted documents, the FPIs are now mandated to submit an undertaking to Designated Depository Participants (DDPs) that the relevant documents will be provided as and when demanded by the regulators or any law enforcement agencies. Further, the SEBI 2013 Circular had also exempted Category III FPIs from submitting proof of address of the BOs, senior management and authorised signatories. Now, it has been decided that, in light of Category III FPIs being high risk investors, a declaration on their letterhead must be provided. A six-month period has been prescribed to furnish the aforesaid documents, from the date of the FPI Circular 1, i.e., 10 April 2018.

Comment

SEBI, *vide* FPI Circular 1, has re-iterated its stance as regards placing certain restrictions on NRIs investing into India through the FPI route, in light of the alternative Portfolio Investment Scheme ('PIS') route available to them. Earlier, NRIs, in case of Category III FPIs, could invest in India through the FPI route as long as they did not hold a majority stake in the investing entity. Further, there was no individual limitation on NRIs investing through Category II FPIs, as long as the FPI was broad based. While the said Circular essentially re-iterates the current position of SEBI on NRI participation through the FPI route, in a subtle way it has imposed a further restriction on NRI participation even for broad based funds which are otherwise eligible to get a Category II FPI license. Essentially, by extending the BO construct and placing restrictions on NRIs/Resident Indians being BO, SEBI has restricted an individual NRI's participation in FPIs to 25%, 15% or 10% based on the nature of the entity and the jurisdiction involved.

While it is appreciated that the underlying intention of the regulator is not to place restrictions on NRI controlled entities being the investment managers of the FPI, the language of FPI Circular 1 may raise certain doubts. It is unclear whether an NRI controlled entity which is not regulated, can act as investment manager of an FPI. Thus, FPI Circular 1 casts a shadow on the existing unregulated investment managers and moreover, on the way forward for the innumerable global funds managed by NRI fund managers or fund managers that are ultimately controlled by Indians and Indian conglomerates. Thus, SEBI would need to clarify its position in respect of such genuine cases so that the investors are not disadvantaged unfairly on account of restrictions on NRI fund managers.

Lastly, it seems as if SEBI, in its fear to address the risk of round-tripping, has swung the pendulum to the other extreme by restricting NRI participation through the FPI route. We hope that more clarity, especially with respect to broad based funds managed by NRI managers, whether Category II or Category III, emerges from the regulator.

PART II: CLARIFICATION OF CLUBING OF INVESTMENTS BY FOREIGN GOVERNMENTS / FOREIGN GOVERNMENT RELATED ENTITIES

Regulation 21, sub-regulation 7 of the SEBI (Foreign Portfolio Investment) Regulations, 2014 (FPI Regulations) restricts the investment by a single FPI or an investor group in the equity shares of a company to 10 % of the total paid up capital of the company. The SEBI Circular titled 'Clarification on clubbing of investment limits of foreign Government/ foreign Government related entities' numbered SEBI Circular No. SEBI/HO/FPIC/CIR/P/2018/66 dated 10 April 2018 (FPI Circular 2) clarified that if foreign Government or their related entities form a part of the same investor group, their investments as FPI will be clubbed for the purposes of calculation of investment limit to ascertain whether the 10 % limit has been breached or not.

In order to determine whether two FPI entities form a part of an investor group or not, the rule under Regulation 23, sub-regulation 3 of the FPI Regulations will be applicable which states that if the same set of UBOs invest through multiple entities, such entities shall be treated as part of same investor group. The FPI Circular 2 clarified that such beneficial ownership in the FPI entities should be of more than 50 % for the FPIs to be treated as forming a part of an investor group. The determination of beneficial ownership of foreign Government or their related entities shall be in accordance in Rule 9 of the PML Rules, as explained in Part I above.

The information with regard to an investor group shall be ascertained by the designated depository participant engaged by an applicant of FPI at the time of granting registration, which shall then be disclosed by such applicant to SEBI at the time of registration in Form A. Further, for information with regard to investment limits by registered FPIs or investor groups, the custodians are under the obligation to inform the depositories of the holdings

by FPIs or investor group, who shall then ensure that the combined holding by the FPIs or investor groups are in compliance with the 10 % limit.

The FPI Circular 2 carves out 3 (three) exceptions to the rule of clubbing of investments of foreign Government or their related entities:

- As per Regulation 21 (9) of the FPI Regulations, in cases where the Government of India enters into agreement or treaty with other sovereign Governments that specifically recognize certain entities to be distinct and separate; or

- Investment by foreign Government or their related entities from provinces / states of countries with a federal structure that have separate investment funds and distinct beneficial ownership; or

- *Vide* letter No. 10/06/2010-ECB dated 6 January 2016, the World Bank Group, *viz.,* IBRD, IDA, MIGA and IFC.

In case the 10 % investment limit is breached by an FPI or investor group, including foreign Government or their related entities, the FPI or the investor group is required to divest their holdings within 5 trading days from the date of settlement of the trades that causes the breach. If such divestment is not undertaken, the FPI or the investor group must choose to classify their investments as foreign direct investment ('FDI') and inform SEBI and the Reserve Bank of India of the change in treatment of their investment immediately.

Comment

Given the growth of sovereign fund in India, the SEBI has received multiple queries with respect to the clubbing of investments by foreign Government or their entities. In light of this, *vide* FPI Circular 2, the SEBI has clarified its position that the rule of 10 % investment limit in a company is applicable on foreign Government or their related entities as well. If two or more foreign Government entities have a common beneficial ownership of more than 50 %, their investments as FPIs will be clubbed for the purposes of ensuring compliance with investment limits.

However, SEBI has provided respite to the foreign Governments wanting to make portfolio investments in India by laying down certain exceptions. In cases where the Government of India has entered into an agreement with another sovereign Governments which specifically permits investments exceeding the 10% limit, the investment restriction under the FPI Regulations will not be applicable. One such example is the investments made in India by Temasek and Government of Singapore Investment Corporation (GIC), both of which are Singapore Government entities. Further, the investment restriction will also be relaxed if it can be established that foreign Government entities from different provinces or states having federal structure have distinct beneficial ownership. The World Bank Group, has also been granted exemption from the 10% limit restriction.

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