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REVISED KYC AND ELIGIBILITY FRAMEWORK FOR FPIs: SEBI WATERS DOWN THE APRIL 10 CIRCULAR

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With the FPIs on tenterhooks since the issuance of the now famous, or rather infamous, circular dated 10 April 2018 (April 10 Circular), following the submission of the report[1] by the working group under the Chairmanship of Shri H R Khan (Working Group) and in-principle acceptance of their recommendations by the SEBI Board, SEBI has finally issued two important circulars on 21 September 2018. *Vide* the two separate circulars, one dealing with Know Your Client (KYC) requirements and the second with the eligibility conditions for Foreign Portfolio Investors (FPIs), SEBI has substantially superseded their earlier April 10 Circular and has provided the much-needed relief and clarity for the FPI community.

Broadly speaking, the revised circulars have accepted the fact which was highlighted by the Working Group that the beneficial ownership (BO) criteria laid down in Prevention of Money-laundering (Maintenance of Records) Rules, 2005 (PMLA Rules) should be used only for KYC reasons and not for determination of eligibility of the FPIs. The salient features of the revised KYC requirements, conditions regarding clubbing of investments and eligibility conditions of FPIs are analysed in Part I and Part II of this Ergo, respectively.

PART I: KYC for FPIs

On 21 September 2018, the SEBI *vide* a circular titled 'Know Your Client requirements for FPIs' numbered CIR/IMD/FPIC/CIR/2018/131 (FPI Circular 1) superseded the directions on 'Know Your Client requirements for FPIs' contained in the April 10 Circular.

The FPI Circular 1 has broadly incorporated all the recommendations proposed by the Working Group on identification and verification of BO of FPIs. The important highlights of the FPI Circular 1 in relation to identification and verification of BO are as follows:

- FPIs need to maintain the list of BO in a prescribed form and share the same with the designated depository participants.
- It has clarified that in case of FPIs organised in the form of limited partnerships, the BO shall be identified both on the basis of entitlement as well as control.

[1] Please refer to our ERGO titled '*SOME BREATHER FOR FPIs: Hits and Misses of the SEBI Committee Report*' dated 14 September 2018, for more details.

- It has retained the concept of identification of BO based on PMLA Rules and applicability of materiality thresholds on look through principle, however, it has clarified that disclosure in relation to intermediate holding structures together with their respective BO would have to be disclosed.

- It has also clearly laid out that the exemption under Rule 9(3)(f) of PMLA Rules for listed companies will not be available for foreign companies thereby requiring even the listed foreign entities to identify their BO.

- The FPI Circular 1 has further clarified that the BO declaration will be applicable to offshore derivative instruments issuing FPIs

- Category I FPIs, including entities in a chain of structure which is eligible to register as a Cat I FPI, are exempt from identification and verification of BO

- The FPI Circular 1 has stressed on the fact that in case of companies / trusts represented by service providers, if the BO exercises controls through means like voting rights, agreements, arrangements etc. then the real BO should be identified, and it should not be a nominee of another person

- Senior managing official (SMO) can be any individual as designated by the FPI but should hold a senior management position and shall make key decisions relating to the FPI

The much-needed clarity for non-compliance of the stipulated KYC norms for FPIs has been brought out by the FPI Circular 1. It has accepted the recommendations proposed by the Working Group with respect to non-compliant FPIs by allowing them a period of up to 6 months from the date of the FPI Circular 1 to comply with the revised KYC norms, which we believe should provide them enough time for transition.

Handling of personal KYC data and data security: With respect to the concerns surrounding security of personal information of BOs, the FPI Circular 1 has proposed security provisions which includes setting up of KYC Registration Agencies (KRA) who shall lock the BO information provided by the FPIs and would provide the information to intermediaries only on 'need to know basis'. The time-period stated in the FPI Circular 1 for maintenance of records by custodians is minimum of 5 years from the date of cessation of the transactions with the said FPI and in cases where a litigation is pending, these records must be maintained till the completion of the proceedings.

Comment

The revision of BO requirements made by FPI Circular 1 is a welcome step as it has brought relief to the industry participants by categorically clarifying that the BO declaration will not impact the eligibility conditions of FPIs. It has also provided much needed clarity with respect to applicability of BO requirements. It has excluded Category I FPIs from identification and verification of BOs which we believe is an informed step as all the Category I FPIs are either government / government related entities and are perceived to be low risk entities.

It would be interesting to see how the data security provisions laid down by the FPI Circular 1 would be received by the offshore investors as the risk pertaining to data breach may still linger because the information will still have to be shared with a third party (KRA).

However, the exception carved out for listed entities by the Working Group has not been incorporated in the FPI Circular 1. While the concerns of SEBI around the quality of listings are understandable, this could pose practical challenges for some overseas listed entities especially where the threshold for BO is reduced to 10%.

Part 2: Eligibility conditions for FPIs

SEBI *vide* circular titled 'Eligibility Conditions for Foreign Portfolio Investors' numbered CIR/IMD/FPIC/CIR/P/2018/132 (FPI Circular 2), has superseded the previous circular dated 10 April 2018 to the extent that the eligibility conditions for FPIs having Non-Resident Indians (NRI), Overseas Citizen of India (OCI) and Resident Indians (RI) as constituents are no longer linked to the BO criteria laid down under PMLA Rules. The key highlights of the said circular are as follows:

- No restriction on FPIs from having NRIs/OCIs/RIs as investors provided their individual holding is capped below 25% of the corpus of FPI and aggregate holding should be below 50%

- The FPI Circular 2 in fact has clarified that RIs are permitted to invest in FPIs as long as such investment is made through the Liberalized Remittance Scheme (LRS) of the RBI, however, the fund has to be a global fund where exposure to Indian securities is less than 50%

- Though the FPI Circular 2 continues to stick to the fact that NRIs/OCIs/RIs cannot be in 'control' of the FPIs as a basic eligibility condition. However, an exception has been made for FPIs which are controlled by investment managers who in turn are directly or indirectly owned/controlled/owned by NRI/OCI/RI, provided such investment manager entities are either: (a) appropriately regulated in its home jurisdiction and registers itself with SEBI as non-investing FPI; or (b) appropriately registered with SEBI if incorporated under Indian laws. Further, an exception on control by NRI/OCI/RI has also been created for 'offshore funds' in respect of which 'no-objection certificate' has been procured from SEBI in terms of the SEBI (Mutual Funds) Regulations, 1996.

- Further, FPIs which are exclusively investing in mutual funds in India will not be subject to any restriction on NRI/OCI/RI participation both in terms of individual ownership as well aggregate ownership.

- The FPI Circular 2 has provided a two-year period to the FPIs to comply with these requirements which period shall commence from the later of (a) the date on which the FPI Regulations are amended to implement the provisions of the FPI Circular 2; or (b) the date of registration of the FPI, whichever is later. A provision has also been made for temporary breaches by an FPI of the above eligibility requirements wherein a cure period of 90 days as proposed by the Working Group has been accepted by the FPI Circular 2.

Comment

While the aggregate cap of 50% on NRI/OCI participation in FPIs will put constraints on certain genre of funds primarily targeting this investor base, it appears that for now the industry will have to learn to live with these constraints. We do hope that government would at some point consider relaxing the aggregate cap of 50% for at least certain categories of institutional investors. Alternatively, the industry needs to wait till the recommendation of

the Work Group to merge FPI and PIS regime takes shape in which case these restrictions may fall away.

The FPI Circular 2 has accepted the recommendation proposed by the Working Group to specifically exclude the PIOs from the application of BO norms altogether which is a prudent step. However, PIOs with OCI card could still find the restrictions constraining as they will have to choose between the flexibility to freely invest in India vs. preserving their status as an 'Overseas Citizen of India', which might not be the best strategic choice to make. May be the answer lies in the recommendation of the Working Group on evaluating the merger of the PIS and the FPI route.

The revised requirements brought by the FPI Circular 2 should broadly deal with the anxiety of the NRI/OCI/RI fund managers who had seen the April 10 Circular as a major blow. The proposed set of eligibility conditions in a general sense should lead to 'business as usual' for most of the NRI/PIO owned fund managers subject of course with the additional administrative burden of getting the manager entities registered with SEBI as a non-investing FPI. Though not a perfect solution from an industry perspective, it appears to be fairly balanced between the expectations of the industry as well as the regulators.

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