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SOME BREATHER FOR FPIS: HITS AND MISSES OF THE SEBI COMMITTEE REPORT

14 September 2018

Introduction

Post the Circular CIR/ IMD/ FPIC/ CIR/ P/ 2018 titled '*Know Your Client Requirements for Foreign Portfolio Investors (FPIs)*' issued by Securities Exchange Board of India (SEBI) dated 10 April 2018 (SEBI Circular), there was widespread confusion around the eligibility of Resident Indians (RI), Non-Resident Indians (NRI), Overseas Citizens of India (OCI) and Persons of Indian Origin (PIO) to hold interests in Foreign Portfolio Investors (FPIs) and invest in FPIs. The SEBI Circular disallowed RIs / NRIs/ PIOs from being beneficial owners (BOs) of an FPI and clarified the position on clubbing of investment limits. Please refer to our ERGO titled '*NRIs: Not Really for Indians? SEBI Tightens FPI Norms*' dated 17 April 2018, for details.

Given the extensive debate among market participants generated by the SEBI Circular and its far-reaching implications on investments in India through the FPI route, a working group constituted by SEBI under the Chairmanship of Shri H R Khan (Retd. Deputy Governor of Reserve Bank of India (RBI) (Working Group) was asked to look into the concerns of various stakeholders like FPIs, Custodians, etc. and suggest changes.

Based on the feedback received, the Working Group has come out with an interim report titled '*Interim recommendations on Know Your Clients Requirements for Foreign Portfolio Investors (FPIs)*' dated 8 September 2018 (Report). SEBI has now invited public comments on the Report.

This ERGO seeks to highlight the proposed recommendations by the Working Group. Based on the fore note of the Report, we understand that the Department of Revenue communicated to SEBI that the BO criteria laid down in Rule 9 (3) of Prevention of Money Laundering (Maintenance of Records) Rules 2005 (PMLA Rules), should be used for the purposes of customer due diligence and not for the change in eligibility for FPIs.

The Report has been divided into four sections:

Section A: Eligibility conditions where NRIs / OCIs/ RIs are constituents of FPIs

Section B: Clubbing of Investment limit

Section C: Identification and verification of BO

Section D: Other aspects

The detailed analysis of each section is provided below:

A. **Eligibility conditions where NRIs / OCIs/ RIs are constituents of FPIs**

The SEBI Circular had communicated that NRIs/ OCIs /RIs cannot be BOs of investing FPIs. There appears to be no manifest rationale behind such exclusion of NRIs/ OCIs / RIs, as the definition of BO under PMLA is typically to provide aid in the KYC process. Tagging the concept of BO as an eligibility criterion for holding FPIs would be unfitting to the concept of BO.

The Report has provided some relief by excluding PIOs (person of Indian origin who do not have an OCI card) from the applicability of these restrictions.

The Working Group has recommended that NRIs/ OCIs / RIs should be allowed to hold instruments in FPIs, subject to certain conditions, *inter alia*, that their individual holding is kept below 25% of the assets under management (AUM) and the aggregate holding is kept below 50% of the AUM of the FPI.

In case of temporary breaches of the above eligibility conditions, the Working Group has recommended to provide a period of 90 days for compliance and in cases where the FPIs still remains non-compliant after the expiry of 90 day period, such FPIs should be disallowed to make any fresh purchases and should liquidate its existing position in Indian securities market in the next 180 days.

Comment

The limits prescribed for NRI investment is a positive recommendation to a certain extent as the SEBI Circular created undue hardship on NRIs/ OCIs / RIs owned FPIs. Further, the restrictions have been made uniform across the nature and kind of vehicles. At this juncture, it would be worthwhile to revisit the erstwhile Foreign Institutional Investor (FII) regime, where in 2010, SEBI did away with the restrictions on Overseas Body Corporates not being eligible to invest / register as FIIs. Based on the said amendment, subject to the FII / sub-account meeting the broad-based criteria, NRIs/ PIOs/ OCIs were eligible to invest up to 100% in a broad based FII / sub-account. With the advent of the FPI regulations, while restrictions were imposed on NRI ownership on Category III FPI, we believe the practice in relation to NRI participation in broad based fund continued for Category II FPIs fulfilling the broad-based criteria.

Thus, we are of the view that the restriction on aggregate NRI participation should be removed for broad-based Category II FPIs as the imposition of such an artificial restriction over and above the requirement of broad based criteria on Category II FPIs is bound to cause unnecessary hardship on funds, including those which have been compliant with the regulations based on the clarifications provided by SEBI in the past since the FII regime.

B. **Clubbing of Investment limit**

Prior to the SEBI Circular, the investments by FPIs were to be clubbed on the basis of common ownership or control of more than 50% as provided under the Operational Guidelines for Designated Depository Participants (DDPs) issued by SEBI on 8 January 2014. The SEBI Circular revised the basis for clubbing of investment limits for FPIs to BOs of FPIs. Given that the ownership of an FPI vests in various investors and the constitution of the investor group

keeps fluctuating, the clubbing of investment limits on the basis of BO did not appear to be feasible. Therefore, the well thought recommendation of the Working Group to restrict the application of the BO criteria under PMLA to the KYC process may resolve the issue created post the SEBI Circular. Further, the Report recommends to exclude clubbing of investment limit of FPIs having common control based on identification of the senior managing officials (SMO).

Comment

The clubbing of investments on the basis of 'control' has been a continuing concern, especially for large groups which have various FPIs which are independently managed by separate teams. As a result of the SEBI Circular, all such FPIs which belong to large groups may get clubbed, thereby significantly restricting the investment opportunities for such investors. The carve out provided by the Report is only limited to FPIs having retail investors, thereby leaving such large groups in a fix. There should be uniformity on the clubbing based on the 'control' aspect and as long as there are genuine third party investors across vehicles, clubbing should not take place merely by virtue of 'control'.

Therefore, to provide relief to these large groups, our recommendation would be the removal of clubbing on the basis of 'control' for funds and vehicles with separate and segregated third party investor bases. The rationale being that clubbing on the basis of SMOs has anyway been carved out.

C. **Identification and verification of BO**

The SEBI Circular does not specifically exempt Category I FPIs, coming from a 'high-risk' jurisdiction, from additional KYC documentation requirements like submitting proof of identity, address documents for SMOs, etc, which should ideally be applicable to Category III FPI. The recommendation of the Working Group to exclude Category I FPIs from providing such additional KYC documentation, considering that Category I FPIs are either government/ government related entities and are perceived to be low risk entities, may be perceived as a wise and prudent step.

The SEBI Circular further provides that where no material shareholder / owner entity is identified in the FPI using the materiality threshold based on controlling ownership interest or on control basis then the BO shall be the SMO. However, the SEBI Circular does not provide any specific definition of SMO and the term could be open to interpretations. Therefore, we agree with the recommendation provided by the Working Group that the ambiguity should be a cleared by providing a definition of 'SMO'.

The Working Group has clarified that the BO declaration on control basis should not be required for a general partner / limited partner structure and taken the view that if they have to disclose BO on control basis then appropriate changes should be made in KYC requirements. We recommend that similar relief should be granted to settlors / trustees of trusts.

Given that, the SEBI Circular does not specifically provide any relaxation to listed companies from identifying its BO, despite the PMLA Rules directing that the test of BO should break at the level of a listed company on a look through basis. The Report has suggested SEBI to explicitly carve out an exception for listed companies, ownership of listed companies keep fluctuating due to continuous trading of stocks on stock exchanges, which we believe is an informed suggestion.

D. **Other aspects**

The Working Group has recommended a time period of 6 (six) months to be given to FPIs to ensure compliance with the new requirements. We agree with the extension proposal as that the KYC compliance will be an extensive exercise given the large number of FPIs in the market and the complexity in their holdings.

The Report has also clarified that the compliance requirements of the SEBI Circular will be applicable to offshore derivative instruments subscribers.

We appreciate the recommendation of Working Group on the need to have a proper policy for disclosure of personal information of BOs. Since, disclosing personal information can be an extremely sensitive issue because of the concerns surrounding data privacy, confidentiality and identity thefts, many investors are extremely cautious to disclose their personal information. Such requirements should not be mandated specifically for offshore investors. SEBI may require the FPIs to undertake a KYC of such information without disclosure to DDP / SEBI.

Further, SEBI should keep in mind that in order to ensure smooth compliance of the new requirements imposed by the SEBI circular, proper guidance and clarifications should also be provided in addition to the relaxation of time period provided for compliance.

Conclusion

The recommendations given by the Working Group and the comments sought by SEBI are a welcome move since SEBI seems keen to take into account market feedback prior to issuing the next set of regulations. It should bring about the much needed clarity on the issues relating to NRI/ RI owned FPIs.

However, there are still certain issues that remain unaddressed, which we feel are important and should be taken into account by the policymakers prior to issuing the next round of clarifications:

1. SEBI needs to reconsider and clarify the deviations made from the original policy in relation to broad based funds. There should be no restrictions on aggregate NRI participation in broad based funds.

2. Any restrictions on NRI participation should have some buffer period for newly established FPIs.

3. NRI / PIO / OCI fund managers should be held at par with offshore fund managers. Merely because of an individual fund manager's nationality, there should not be any restrictions. Thus, any restrictions on NRIs should only be with respect to 'investments' and there should be no restrictions on the basis of 'control'.

4. Policy regarding disclosure of personal information to the DDPs should be reconsidered as the international investors are generally extremely sensitive towards disclosure of personal information. SEBI should reconsider provision on disclosure of such personal information to DDPs / SEBI. An alternative to the policy regarding disclosure of personal information could be imposition of obligation on FPIs to disclose personal information to SEBI directly only when SEBI asks for such information in contentious situations. Alternatively,

instead of disclosing personal information, investors in FPIs can provide reference letters from recognised / regulated intermediaries.

5. Further, there is no rationale for differentiating between OCIs and PIOs. They are both foreign passport holders. Thus, even OCIs should be carved out from the restrictions on NRIs.

6. There is a need to bring clarity on restrictions placed on clubbing of investment limits on the basis of 'control'. Any clubbing of investment limits should ideally be in respect of entities having common financial interest with third party investors and should not be on the basis of 'control'.

Lastly, to end on a happier note, the most interesting aspect which seems to be coming out of the Report is the merger of the FPI regime with the NRI regime. This could be a game changer for all overseas investments in India and would bring NRIs at par with their offshore counterparts for investments into their beloved country.

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