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Three Casualties Of A Recent SEBI Diktat: FPIs, NRIs And Indian Investment Managers

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One circular and three casualties- SEBI's recent circular on know your customer requirements has non-resident Indians, foreign portfolio investors, and India based investment managers worried. While custodians and lawyers are in the process of seeking clarity from the market regulator, they say if SEBI maintains its stance, it would impact existing FPI structures.

Impact On NRIs

NRIs can invest in Indian equities either directly or take the FPI route. FPIs need to register with the Securities and Exchange Board of India and are divided into three categories based on their risk profile and the consequent KYC requirements.

- Category I includes government entities.
- Category II includes regulated broad-based funds.
- Endowments, charitable societies, foundations, family offices fall under Category III.

So far, NRIs generally invested through Category II FPI funds and were mandated to keep their shareholding in such funds below 50 percent.

There are multiple reasons as to why NRIs choose to come via the FPI route, Rushabh Maniar, partner in the funds practice team at AZB & Partners told BloombergQuint. Not everyone has investment acumen. Besides, it’s easier than registering as an FPI and managing the accompanying paperwork, he added.

> There are multiple benefits and that is the reason NRIs prefer to make investment through offshore funds, get exposure in various jurisdictions because your FPI fund may not be investing only in India and only a part of NRI investments may be coming into India

Rushabh Maniar, Partner, AZB & Partners

But this comfort will no longer be available to NRIs….at least not above a certain threshold.

In its recent circular, SEBI has stated that NRIs can no longer be beneficial owners of FPIs. Beneficial ownership for FPI funds - structured as a company or trust - has been defined to mean 25 percent interest and control. The threshold for identifying beneficial ownership of FPI funds structured as partnership firms is 15 percent.

NRI Beneficial Ownership Threshold

- Company/Trust: 25%
- Partnership: 15%

Existing FPI funds where NRIs are beneficial owners have been directed to either change their structure or close their position in the Indian market within 6 months.

While the intent of regulator is unclear, going by the long history of the policy on NRI investments, it could be money laundering or round tripping concerns that may have prompted this directive, Pratibha Jain, head of the regulatory practice at law firm Nishith Desai Associates, pointed out. The implications would be far reaching, she said.

> If money-laundering is the concern, then the person who has control should be looked at for the test. Let’s say it is a discretionary trust where the investment manager decides how to make the investment. It should really not matter what the ownership structure is as long as the owners are not making decisions vis-à-vis investments into India.

Pratibha Jain, Head-Regulatory Practice, Nishith Desai Associates

The SEBi circular extends the rule to look at all NRI investments in an FPI in total. If together, the combined ownership of NRIs exceed any of the beneficial ownership thresholds that too will not be permitted.

The fact that NRI investments will be looked at in aggregate makes it even more restrictive, especially for broad-based funds that target NRIs due to their interest and understanding of Indian markets, she added. Funds are categorised as broad-based if they have a minimum of 20 investors with no single individual investor holding more than 49 percent units of the fund. Such funds are preferred by NRIs since they can avail a Category II licence and hence have a lot more freedom in terms of the investments they can make, Jain explained.

Maniar added that NRIs may now prefer to invest through multiple FPIs such that they don’t breach the beneficial ownership threshold now prescribed.

Impact On FPIs

FPIs are currently allowed to invest up to 10 percent in a listed Indian company. SEBI has now said that the investment limit of FPIs will be clubbed if they have the same beneficial owner.

This means if NRI ‘X’ is a beneficial owner of two unrelated FPI funds ‘A’ and ‘B’, then A and B will be considered group entities, Jain explained. If, when combined, the funds own more than 10 percent in a listed Indian company, it will be treated as foreign direct investment and one of them will have to sell within five days for their investment to be treated as FPI.

This get complicated further since control too will breach the beneficial ownership threshold, Maniar pointed out.

> As per the definition, a person controlling the fund structured as a corporate entity will become the beneficial owner even if he doesn’t have any ownership interest. Entities like the manager - because the manager makes investment decisions. If that is the case, then funds with common managers will breach the 10 percent limit.

Rushabh Maniar, Partner, AZB & Partners

Impact On Indian Investment Managers

The SEBI circular doesn't just have NRIs and FPIs worried; India-based investment managers have been affected too since they can no longer be beneficial owners of FPIs. Experts quoted in this story pointed out that many investment managers, based in India, set up offshore funds to attract NRI money, control them and invest some of their own funds to show that they too have their skin in the game.

‘We know of structures where Indian managers have specifically gone to SEBI for approval to set up NRI-owned offshore funds,’ Jain explained. It is very typical for investors to ask investment managers to put in their own money, she said.

> SEBI has not even provided a threshold. Even if I, as an Indian investment manager, put a 5 percent equity in the fund which has taken a FPI registration, I will still be in violation of this circular since I have control.

Pratibha Jain, Head-Regulatory Practice, Nishith Desai Associates

Control- a trigger for beneficial ownership- comes from management rights that some Indian investment managers have in the offshore funds meant to attract NRI investments. Currently, the custodians are talking to SEBI to get clarity on this, Jain added.