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BQExplains: Why SEBI's New KYC Norms Have Spooked Some Foreign Investors

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A SEBI circular issued in April 2018 laid down new know-your-customer norms for foreign portfolio investments in India. These have impacted non-resident Indians, foreign portfolio investors, and India-based investment managers and BloombergQuint reported that some foreign funds have started winding up or reworking their structures to meet these new norms. One investor body estimates that "about $75 billion worth of investments will need to be unwound in a short period". Market regulator SEBI has termed that as "preposterous".

BQ explains what's going on and which numbers to believe...

What Does The SEBI Circular Say?

On April 10, Securities and Exchange Board of India issued a circular on enhancing KYC norms for Foreign Portfolio Investors. As per these norms Resident Indians, Non Resident Indians, Persons of Indian Origin, Overseas Citizens of India cannot be beneficial owner of a fund investing in India.

A beneficial owner is a person who, directly or indirectly, derives the benefits of ownership.

According to the norms, beneficial ownership was triggered if any of the investors listed above owned more than the defined thresholds in a fund—25 percent in case the fund is a company, 15 percent in case the structure is a partnership and 10 percent if the investment was being made via a 'high risk jurisdiction'. Identification of which countries qualify as high-risk jurisdiction has currently been left to the discretion of custodians. That led to considerable confusion as custodians couldn't agree on a list and it's likely SEBI may do away with this provision.

But wait, there's more to this than just individual thresholds...

- If together, the combined ownership of NRIs exceed any of the beneficial ownership thresholds that too will not be permitted.
- FPIs are currently allowed to invest up to 10 percent in a listed Indian company. The SEBI circular says that the investment limit of FPIs will be clubbed if they have the same beneficial owner.
- Control too can trigger beneficial ownership, according to the SEBI circular. That means, a person controlling the fund structured as a corporate entity will become the beneficial owner even if he doesn't have any ownership interest.

The regulator has directed funds who are not in conformity with the rules to change their structures or unwind their current position in the Indian securities market. The deadline to comply ends in December 2018.

Who Is Impacted By It?

As mentioned above, these new norms impact:

- NRIs
- PIOs
- OCIs
- RIs
- India-based Investment Managers

None of them can be beneficial owners of a foreign portfolio investor (fund, irrespective of structure) investing in india.

Foreign funds with majority holding of NRIs, PIOs, OCIs and RIs will either need to look for alternative structures, that ensure there is no such beneficial ownership breach, or unwind their positions.

Many small funds are opting for unwinding and larger-sized funds may prefer restructuring.

Why Has SEBI Done This?

The SEBI circular is terse and poorly drafted. It doesn't offer any explicit explanation for the change in norms.

While the intent of regulator is unclear, going by the long history of the policy on foreign 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, told BloombergQuint in an interview in May.

That's a fair assumption as the new norms apply to Indians, resident and non-resident, and those of Indian origin.

What Quantum Of FPI Investments In India Could Be Impacted?

Nobody knows. Because funds have been opaque about beneficial owners. Which is what prompted SEBI to change its norms some might say. Without data on beneficial owners, it's tough to ascertain what quantum of investments in India will be impacted. But here are some numbers to work with...

All investments that come under these new norms are via broadbased funds, which currently have Rs 5,39,432 crore in assets under custody in India, or via investment managers/advisers—who have assets in custody worth Rs 85,881 crore. That's a total $87 billion as of July 2018, as per data published on the NSDL website.

These numbers correspond to an estimate being shared by Nandita Agarwal Parker, president of Asset Managers Roundtable in India, an investor body that's sprung up to lobby against these new SEBI norms. She told BloombergQuint "...about $75 billion worth of investments will need to be unwound in a short period, causing a stock market crash and a sharp fall in the rupee in an election year".

But it would be an exaggeration to assume that all this money would leave India on account of these new norms. Because not all this money becomes tainted or is impacted by the SEBI norms.

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