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The Curious Case of Foreign Funding

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The stock market has been volatile in the last few days. After a stellar August month, macro concerns have taken over in September and we are seeing a correction, perhaps more than what we bargained for. Adding to this volatility is the upcoming deadline of SEBI's controversial April 10th circular which seeks to place curbs on persons of Indian origin (PIO's) and non-resident Indians (NRI's) from controlling foreign portfolio investment (FPI) coming into India. An FPI (from an Indian context) is an investment vehicle in which money is pooled by foreign investors and enables them to purchase stocks, bonds or other financial assets in India. FPI's investing in India can be run and managed by various persons including foreigners, NRI's, PIO's, OCI's (overseas citizens of India) etc.

FPI rules state that NRI's and PIO's are not allowed to be the persons who ultimately own or control an FPI (also called as beneficial owners (BO's) of FPI funds). The only parameter to classify a person as a beneficial owner (thereby disqualifying the FPI if BO's are NRI's and PIO's) was based on economic interest. So, FPI's investing in India, with NRI's and PIO's as their fund managers would position themselves in a such as way, so as to avoid being classified as beneficial owners according to Indian FPI regulations. The April 10th circular published by SEBI seeks to include a greater number of FPI fund managers within its definition of beneficial owners, thereby disqualifying the fund from investing in India. It states that beneficial ownership should not be determined based on economic interest only but should also consider who controls the fund and further goes on to mention that in cases where there are no visible beneficial owners, the senior management officials will be considered as beneficial owners. The circular also enhanced know your customer (KYC) norms for FPIs.

This stance taken by SEBI created panic amongst several India dedicated FPIs, since a lot them were managed by Indians or Indian entities. FPI lobby group AMRI (Asset Manager's Roundtable of India) cried foul and predicted that the move by the market regulator could lead to 75 billion $ worth of investments being under threat and called for immediate intervention by regulators. Fund houses that were affected are already considering winding up some of their operations, creating strategic partnerships and change in shareholding to avoid being on the regulator's radar. At a time when foreign exchange is worth its weight in gold amid rapidly declining rupee, widening current account deficit and rising oil prices, can we really afford to risk an avenue for inflow of much needed foreign funds?

The government and market regulator was quick to come out in defence of their actions with Economic Affairs Secretary S C Garg stating that there is nothing new in the circular and that the deadline has been extended by two months until December. Market regulator SEBI termed claims of 75 billion $ worth of outflow as "preposterous and highly irresponsible". Making a comparison between the Indian position and regulations concerning FPI investments elsewhere, Nandita Agarwal Parker, president of the AMRI noted "The world over, people of Chinese origin manage a lot of Chinese funds. Now, the Nigerians or the Russians can manage funds investing into India, but those of Indian origin can't. No country in the world does this and we are having a tough time explaining to institutional investors why India is doing this,"

With general elections around the corner, the Modi government perhaps wants to block off all possible sources of funding for opposition parties in an effort to cripple them. When one analyses it from this angle, perhaps it is not an irrational move to strictly scrutinize all avenues of foreign fund flows into the country whether it be by way of FPI or otherwise. A relevant statement made by Nishith Desai of Nishith Desai & Associates, a reputed law firm was "The government may be keen to fix money laundering and nobody questions the need for KYC norms, but this circular also ends up treating all NRI fund managers as possible conduits for money laundering". The government's official stance on these measures taken is to prevent round-tripping of money and to curb tax evasion.

Perhaps in a move to assuage market participants not to panic, market regular SEBI in an unexpected move decided to hedge its bets and may dilute some provisions from the circular and is also mulling exempting PIOs from the ambit of its KYC and easing investment norms for NRI's. It also referred the matter to H.R. Khan led committee, set up for an easing of FPI access norms. With the final decision yet to be known, the actions of the regulator are being closely monitored not only by the foreign investor community but also the country at large who are very keen to observe as to what length the Modi government will go to drip dry its opposition.