

• Posted: Fri, Oct 1 2010. 11:26 PM IST

# 11% FIIs barred from new buys

Many entities have missed the regulator's 30 Sep compliance deadline for disclosures on investor base

N. Sundaresha Subramanian & Anirudh Laskar

Mumbai: Capital market regulator Securities and Exchange Board of India (Sebi) has banned 197 foreign institutional investors (FIIs) and 342 sub-accounts from taking fresh positions in both equity shares and the derivatives market.

In a late Thursday development, Sebi said these entities had missed the 30 September deadline for complying with the disclosure norms regarding the investor base.

These FIIs and sub-accounts cannot take fresh positions in the cash and derivatives markets, but can retain their current positions or sell off.

As on 1 October, there were 1,726 FIIs and 5,529 sub-accounts registered with Sebi. This means 11.4% of FIIs and a little over 6% of sub-accounts will not be able to buy shares.

FIIs, the driving force behind the recent surge in Indian markets, invested \$19.25 billion (around Rs86,050 crore today) till 30 September, the highest in a year ever since India opened doors for this class of investors in 1993.

The Bombay Stock Exchange's (BSE) key index, the Sensex, rose 1.87% to end at 20,445 points on Friday, 428 points shy of its lifetime high.

"In any market, you have to provide all the information required by the regulator. So to that extent, Sebi's decision is justified," said U.R. Bhat, managing director, Dalton Strategic Partnership Llp (DSP), adding that if FIIs are not disclosing their structure, it may mean there are aspects that are non-compliant.

"The impact on the markets may not be much because many of them already knew that this was coming," he said.

That may well have been the case as FIIs continue to buy Indian stocks, pushing the Sensex higher on Friday. Going by BSE's provisional data, FIIs bought shares worth \$410.34 million.

"Sebi's order may not have any immediate impact as practically speaking less than 10% of the FIIs/sub-accounts are restricted and many of them may not necessarily be very active in India," said Siddarth Shah, partner, Nishith Desai Associates, a Mumbai-based international law firm. "The order does take away some structural flexibility from FIIs, but Indian conditions may be too compelling to be bypassed by FIIs at this moment."

Funds of ABN Amro Bank, Standard Chartered, Société Générale and Bank of New York are among the banned entities. Sub-accounts from across the world—from Wall Street heavyweights such as Goldman Sachs, Morgan Stanley and Merrill Lynch, to West Asian funds such as Aberdeen Asset Management Plc and Abu Dhabi Investment Authority—have been deemed non-compliant.

FIIIs invest in India through multiple routes—some invest directly; others come in through sub-accounts. While both invest in India as a single entity, they collect money through various underlying vehicles.

“Many of these entities invested in India as one, but collected money as different entities,” said an executive with a leading custodian, on condition of anonymity. “Under this structure, one fund will have several share classes and each class will have a separate portfolio. These were similar to the portfolio management schemes run in India.”

Custodians keep custody of shares and securities purchased by foreign investors.

On 15 April, Sebi had asked for certain disclosures by the end of September regarding such underlying share classes in the interests of greater transparency and to ensure that none of the underlying entities were protected cell companies (PCCs).

Sebi had asked all FIIIs, structured as multi-class vehicles (MCVs), to have at least 20 individual investors for each share class, in case of a segregated portfolio. This would have broad-based holdings at the share class level, and brought in more institutional capital rather than individual investments.

“Many of the FIIIs banned are MCVs and they have been banned for failing to comply with broad-basing norms,” said Shah of Nishith Desai Associates, pointing out that it takes time and capital to broad-base MCV share classes.

“Some MCVs are also trying to collapse the existing structure and just become a single class vehicle,” Shah said, adding that the restructuring exercise would take time. “When Sebi comes out with a revised list in maybe a month’s time, many of these names might not be there.”

Another popular investment vehicle is through many underlying cells in a fund. When these cells are registered as a PCC, they are insulated from the portfolio risks of other cells in the fund.

Uncomfortable with such an arrangement, Sebi had in December 2009 banned UK lender Barclays Bank Plc from issuing offshore derivatives after it was found making false disclosure. At the time, Sebi had discovered that the ultimate beneficiary was Pluri Emerging Companies PCC Cell E Emerging Markets Growth Fund, a protected cell company

Subsequently, Sebi had asked for details of whether underlying entities were a PCC, said the official at the custodian agency quoted earlier.

“I think Sebi’s mandate was very clear when the order was put out in April. As far as PCCs are concerned, the regulator has had a discomfort since long as in their view there is a certain degree of opaqueness with PCCs,” Shah said, noting that the regulator has cited the involvement of PCCs in stock market scams. “Now they have just formally closed the route for this class of FIIIs,” he said, but added that most of the FIIIs restricted are not PCCs.

A number of pension funds have also been deemed non-compliant. The list includes Citigroup Pension Plan, City of Los Angeles Fire and Police Pension System, Southern California Edison Company Retirement Plan Trust, Stena Line (UK) Pension Scheme, UPS Pension Plan, State of New Jersey Common Pension Fund D and the trustees of the Mowlem Staff Pension and Life Assurance Scheme.

Lawyers said failure to disclose cannot be assumed to imply a violation of broad-basing criteria. “Many of the funds who have not complied would be long-only funds who may not be frequent traders. They may not be looking at investing any time soon. Further, there is no restriction on selling off your position even if you are non-compliant, so they

may be taking it easy," said another lawyer from a foreign brokerage who did not want to be named.

"KYC (know your customer) is a global issue today (and) Sebi is concerned because there is not enough transparency at present," said Bhat of DSP. "The regulator wants to know who are the ultimate investors for the FIIs, and that is why it is going through each layer."

He also predicted that when these entities comply with the norms, Sebi will lift the ban on them.

*n.subramanian@livemint.com*