02 June 2023

EY Regulatory Alert

SEBI consultation paper for mandating additional disclosures from certain Foreign Portfolio Investors

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Executive summary

This alert summarizes a recent consultation paper released for public comments by the Securities and Exchange Board of India on 31 May 2023 outlining a framework for mandating additional granular disclosures from certain Foreign Portfolio Investors (FPIs). The framework which is being proposed is aimed to prevent violation of Minimum Public Shareholding rules and to guard against possible misuse of the FPI route to circumvent the requirement of Press Note 3[1].

The consultation paper classifies FPIs in three categories based on a risk profile – Low, Medium and High and proposes that only FPIs forming part of the High-risk category shall be required to adhere to the additional disclosure requirement.

The last date to provide comments is 20 June 2023.

[1] Press Note 3 dated 17 April 2020 provides that investment by an entity from a country which shares land border with India or where the beneficial owner of an investment into India is situated in/ citizen of any such country, shall only be under the Government route. Press Note 3 currently does not apply to FPI investments.

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Background

- FPIs are regulated by the Securities and Exchange Board of India (SEBI) and are permitted to invest in, *inter-alia*, shares of listed companies.
- The SEBI (FPI) Regulations, 2019 provide that investment by FPIs and its investor group[1] in equity shares of each company cannot exceed 10% of the paid-up equity capital of such company.
- Further, the Operational Guidelines issued by SEBI for FPIs and Designated Depository Participants (DDP) in 2019 provide that FPIs are required to provide Know Your Client (KYC) related information/ documents based on the category under which they are registered and the jurisdiction from which the investment is made. The KYC details also, *inter-alia*, include details in respect of beneficial owners (BO)[2], being natural persons who ultimately own/ control the FPI.
- While the above measures have been implemented, it has been observed by SEBI that the FPI route is being used by investors to (a) concentrate a substantial portion of their equity portfolio in a single investee company/ company group; or (b) circumvent the restrictions imposed by Press Note 3 (PN 3)[1].
- Given the above, SEBI has on 31 May 2023 released for public comments, a Consultation Paper (CP) outlining a framework for mandating additional disclosures from FPIs with the objective of enhancing trust and transparency in the Indian securities market and enabling greater investor protection.
- This alert summarizes the key aspects of the CP.

Issues identified in the CP and the need for additional disclosures from FPIs

<u>Issue 1: Concentrated group investments by FPIs and potential circumvention of SEBI regulatory requirements</u>

- The Securities Contracts (Regulation) Rules, 1957 read with Regulation 38 of SEBI (Listing Obligations and Disclosure Requirements) Regulations, 2015 makes it mandatory for entities who have listed their equity shares on a stock exchange to maintain a minimum public shareholding (MPS) of 25%. This ensures balance of promoter and public shareholding and reduces volatility in the market.
- In the view of SEBI, such concentrated investments (being near static and maintained for a long time) could raise the concern of potential misuse of the FPI route by promoters of a single investee company/ group (or other investors acting in concert) for circumventing regulatory requirements of maintaining MPS. In such cases, the apparent free float in a listed company may not be its true free float thereby increasing the risk of price manipulation in such scrips.

<u>Issue 2: Misuse of the FPI route for potential circumvention of PN 3 stipulations</u>

- PN 3 was introduced by the Government of India to mitigate the risks of opportunistic takeover/ acquisition of Indian companies. While PN 3 is not applicable to FPI investments, in the view of SEBI, the FPI route could potentially be misused to circumvent the stipulations of PN 3.
- As per SEBI, in certain instances, it has observed that while the FPI itself may be situated out of a non-land bordering country, the investors in such FPIs may be based out of land-bordering

[1] Investor Group is defined in the SEBI (FPI) Regulations, 2019 to mean multiple FPIs, directly or indirectly, having common ownership of more than 50% or common control. Further, 'control' has been defined to mean right to appoint majority of directors or to control the management or policy decisions exercisable by a person or persons acting individually or in concert, directly or indirectly, including by virtue of shareholding or management rights or shareholders agreements or voting agreements or in any other manner.

[2] As per SEBI Operating Guidelines, BOs are required to be identified in accordance with Rule 9 of the Prevention of Money-laundering (Maintenance of Records) Rules, 2005.
Rule 9(3) of the aforementioned Rules specifies the thresholds based on ownership, or entitlement to capital or profits (i.e., economic interest), for identifying the BO of legal entities. The thresholds are 10% for companies and trusts, and 15% for partnerships etc. It also specifies that BO includes those natural persons who exercise ultimate effective control over a legal person or arrangement.

countries thereby leading to violation of PN 3.

Need for additional disclosure

- To address the aforementioned issues, SEBI proposes to obtain granular information from certain FPIs regarding BO based on ownership, economic interest in and control of FPIs. While the extant regulations require FPIs to provide BO details, there are limitations in the information provided, on account of the following reasons:
    - Due to materiality thresholds being applied to identify BOs (either via ownership, economic interest or control), details of all underlying investors with ownership, economic interest or control in entities below the threshold is not being submitted.
    - A natural person holding the position of Senior Managing Official is identified as the BO where no natural person is identified on the basis of control through ownership, economic interest or control through other means.
- Accordingly, it is proposed to mandate enhanced transparency measures, for fully identifying all holders of ownership, economic, and control rights, for objectively identified FPIs that fulfil certain criteria.
- Such identification is proposed to be done on a "look-through basis" down to the level of natural persons, public retail funds or large listed corporates without applying any materiality thresholds, and notwithstanding any equivalent prevention of money laundering rules or secrecy laws that may be applicable in other jurisdictions (including tax havens, if any).

Proposal

- All FPIs are proposed to be categorized in three categories - Low Risk, Moderate Risk and High-Risk as follows:
    - Low risk - Government and government-related entities such as central banks, sovereign wealth funds, etc.
    - Medium risk - Pension Funds or Public Retail Funds[3] with widespread and dispersed investors in such funds provided the DDP is able to independently validate and confirm such status.
    - High-risk - Balance FPIs not falling into the above categories are classified as high-risk.
- Low and moderate risk FPIs will not be required to comply with the additional disclosure requirements.
- Based on certain conditions (discussed in an **Annexure** below), identified high-risk FPIs will be required to comply with the additional disclosure requirements as mandated.
- Once the framework is implemented, high-risk FPIs will be required to submit an undertaking confirming that they have suitable mechanisms/ agreements in place with their investors (on a full look through basis), which shall include waiving off their privacy rights in their respective home jurisdictions, to allow for submission of additional granular disclosures to SEBI/ DDP where required:
    - Entities seeking to register as FPIs – At the time of registration
    - Existing FPIs – Within 6 months of issuance of the guidelines.

[3] Public retail funds means - (i)mutual funds or unit trusts which are open for subscription to retail investors and which do not have specific investor type requirements like accredited investors; (ii) insurance companies where segregated portfolio with one-to-one correlation with a single investor is not maintained; and (iii) pension funds.

Comments

The Consultation paper has been released by SEBI with the stated objective of fostering greater trust and transparency in the Indian securities market ecosystem and for greater investor protection. While providing the granular data of natural persons of all entities on a full look through basis as proposed by SEBI seems cumbersome, the said requirements pertain to only those high-risk FPIs (i) that have concentrated investments in a single corporate group or (ii) the size of their overall equity AUM exceeds INR 25,000 crores (approx. US$ 3 billion). Further, SEBI proposes to implement objective criteria for identifying high-risk FPIs.

FPIs owned and controlled by Government entities, pension funds and public retail funds with a wide and diverse retail investor base, funds tracking global indices of which India forms a part are all proposed to be exempted from the additional requirements. However, this may exclude FPIs who may have diversified ownership by say institutional investors, hedge funds, family offices, broker dealers etc. As per SEBI's own estimate, approximate 6% of total FPI equity AUM may be identified as high-risk FPIs. Market participants may have to evaluate the impact of the changes and could consider making appropriate representations to SEBI. The last date to provide comments is 20 June 2023.

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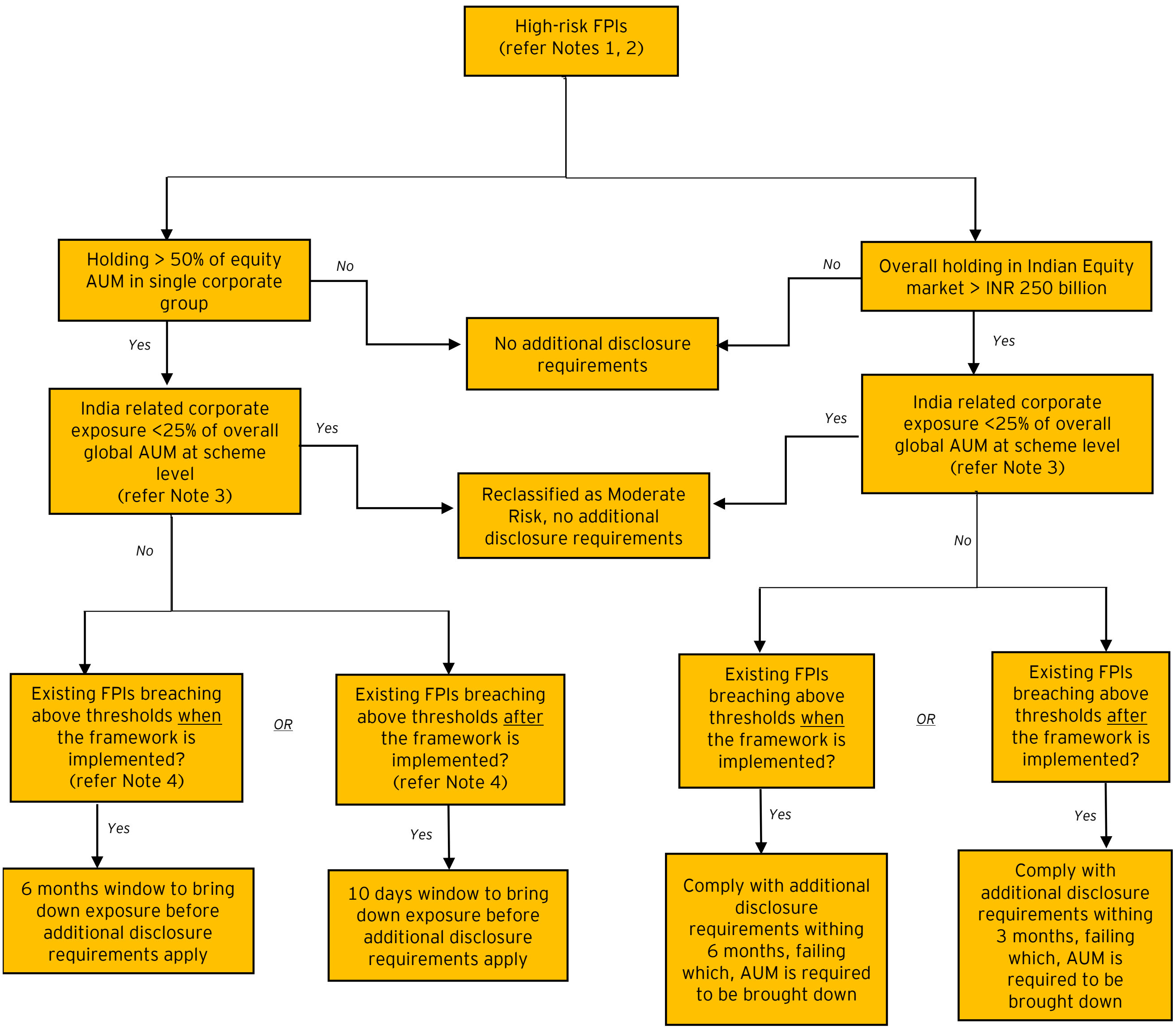
Annexure



Note:

1. *Failure to provide additional granular disclosures would render the FPI registration invalid and FPI would be required to be wound down in 6 months*
2. *All material changes must be communicated to DDP within 7 days*
3. *Subject to the ability of the DDP to independently validate the same*
4. *Special Circumstances – FPIs in process of winding down: No additional disclosure if FPI is wound down in 6 months; - New FPI: Allowed to cross threshold for first 6 months without any additional disclosures being applicable*

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