



Consultative paper on managing/advising of Offshore Pooled Assets by Local Mutual Fund Managers

Background

1. The extant regulation 24(b) of SEBI (Mutual Funds) Regulations, 1996, (SEBI MF Regulations,) inter-alia, allows an Asset Management Company (AMC) to undertake business activity of management and advisory of offshore pooled assets / fund. For managing an offshore fund it is allowed to appoint the same fund manager who is managing domestic scheme, only if, the investment objective and asset allocation of domestic scheme and offshore fund are same and the portfolio is replicated (atleast 70% as per SEBI circular dated February 28, 2012) in both the funds managed by that fund manager, otherwise, a separate fund manager is required to be appointed for managing / advising an offshore fund. Further, such offshore fund has to be a broad based fund i.e. the fund has at least twenty investors and no single investor accounts for more than twenty five percent of corpus of the fund. (The extract of regulation is placed at **Annexure A**)
2. Earlier AMCs were allowed to undertake management and advisory activities for various verticals such as mutual funds, pooled assets including offshore funds, PMS, advisory services, etc. However, in order to address the conflicts that were arising among these verticals, in 2011, AMCs, whose primary activity is to manage mutual funds, were mandated to restrict its other activities in two buckets i.e. (i) management of funds of other broad based entities and (ii) other activities like PMS and advisory services, while meeting separate regulatory requirements for each of these buckets.

The above requirements were introduced pursuant to the approval by SEBI Board in its meeting held on July 28, 2011. The Board Agenda in this regard is available at http://www.sebi.gov.in/cms/sebi_data/boardmeeting/1313055711752-a.pdf.

Proposal from the industry

3. The feedback from the market suggests significant increase in interests of global investors towards Indian capital markets and specifically in equity markets. Currently, a small proportion of Foreign Portfolio Investors (FPI) investment is being managed / advised by Indian AMCs. Considering the long term track record of Indian mutual funds and a well developed regulatory regime, there is a significant potential for the global capital being invested in India to be managed / advised by local mutual fund managers. The prospective FPIs also prefer that the investment team or the fund manager who is managing domestic mutual fund scheme should manage / advise their capital too.
4. The industry represented that under the extant regulations, local mutual fund managers face the following challenges and constraints in managing / advising offshore pooled assets / funds:
 - a. Regulatory requirements of the jurisdictions governing offshore funds have some constraints which may not be applicable to domestic mutual fund schemes or vice versa.



For e.g. UCITS compliant funds have a restriction in terms of total cumulative exposure to the top ten companies in the portfolio. This is not applicable to domestic mutual fund schemes and thereby acts as constraint in achieving replication of portfolio. The stock level restrictions applicable to FPIs investing in India may be another hindrance in achieving replication.

- b. Replication of portfolio also becomes difficult to achieve as the investment objective, investment strategy and the benchmark for each of the funds, including offshore funds, managed by local fund managers, are different. For instance majority of offshore funds follow MSCI India Index as their benchmark while none of the local funds follow MSCI India Index. The composition of MSCI India Index is different as compared to local benchmarks such as NIFTY, SENSEX, CNX 500, BSE 100 or BSE 200.
 - c. The regulation does not allow for transactions in opposite directions i.e. buy and sell between the two funds viz domestic fund and an offshore fund. The inflow / outflow pattern of the two funds can be substantially different and may be in opposite directions. This may be seen as a limiting factor.
 - d. Further, restriction that domestic mutual fund managers can only manage offshore pooled assets / funds which satisfy the criteria of broad base, i.e. at least 20 investors with no single investor holding more than 25 percent of corpus of the fund, makes FPIs ineligible as under SEBI (Foreign Portfolio Investors) Regulations, 2014 (FPI Regulations), broad base means at least 20 investors with no single investor holding more than 49 percent in the pooled fund. Further, under FPI Regulations, broad based can also be achieved on a look-through basis.
5. Introduction of FPI Regulations has been a significant step towards simplifying access to Indian capital markets and have also streamlined categories of foreign investors. Category I covers Government and Government related investors such as central banks, government agencies, sovereign wealth funds and international or multilateral organizations or agencies while Category II, inter-alia, covers -
- a. Appropriately regulated broad based funds such as mutual funds, investment trusts, insurance/reinsurance companies
 - b. Appropriately regulated persons such as banks, asset management companies, investment managers/advisors, portfolio managers
 - c. Broad based funds that are not appropriately regulated but whose investment manager is appropriately regulated
 - d. University funds and pension funds
- (Extract of FPI categories is placed at **Annexure B**).
6. From the above, as the Category I and Category II FPIs are distinct, well defined and are regulated in their respective local jurisdictions, it was represented that requirements as laid out in Regulation 24(b) may not be applicable in respect of funds managed/advised by local mutual fund teams / fund manager in regards to Category I FPIs and Category II FPIs.



7. The above representation was also discussed in Mutual Fund Advisory Committee (MFAC) in its meeting held on December 22, 2014. The committee opined that the extant restrictions on managing /advising of offshore pooled assets /funds by AMCs were introduced during the period when the definition of foreign investors were not as precise as it is defined currently. The introduction of FPI Regulations is seen as a significant step towards simplifying access to Indian capital markets and has also streamlined categories of foreign investors. Thus, as the Category I FPIs and Category II FPIs are distinct, well defined and are regulated in their respective local jurisdictions, the requirements as laid out in regulation 24(b) i.e. appointment of separate fund manager, replication of portfolio and the criteria of 20 investors with no single investor holding more than 25% may not be applicable to offshore pooled assets / funds managed / advised by team of local AMCs in regard to both these categories of FPIs.

Recommendations

8. Keeping in view the challenges faced by the local fund managers in managing offshore pooled assets and the introduction of FPI Regulations which has rationalized the investment routes and monitoring of foreign portfolio investments and also streamlined categories of foreign investors, it is proposed that the requirements laid out in regulation 24(b) of SEBI MF Regulations i.e.
- i. appointment of separate fund manager;
 - ii. replication of portfolio;
 - iii. the criteria of 20 investors with no single investor holding more than 25 percent;
- may not be applicable to funds managed / advised by local fund managers of AMCs in regard to (i) Category I FPIs which includes government and government related entities and (ii) broad based Category II FPIs, as Category II includes both broad based entities such as mutual funds, investments trusts, etc. and persons such as portfolio managers, investment managers, asset management companies, banks, etc.

Request for Public Comments

Public comments are invited on the above recommendations. The comments may be emailed on or before February 2, 2015 to paragb@sebi.gov.in and vimalb@sebi.gov.in or sent by post to:-

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Extract of regulation 24 of SEBI (Mutual Funds) Regulations 1996

"Restrictions on business activities of the asset management company

24. The asset management company shall, -

(a) not act as a trustee of any mutual fund;
(b) not undertake any business activities other than in the nature of management and advisory services provided to pooled assets including offshore funds, insurance funds, pension funds, provident funds, if any of such activities are not in conflict with the activities of the mutual fund:

Provided that the asset management company may itself or through its subsidiaries undertake such activities, as permitted under clause (b), if, -

- (i) it satisfies the Board that bank and securities accounts are segregated activity wise;
- (ii) it meets with the capital adequacy requirements, if any, separately for each such activity and obtain separate approval, if necessary under the relevant regulations;
- (iii) it ensures that there is no material conflict of interest across different activities;
- (iv) the absence of conflict of interest shall be disclosed to the trustees and unit holders in scheme information document and statement of additional information;
- (v) there are unavoidable conflict of interest situations, it shall satisfy itself that disclosures are made of source of conflict, potential 'material risk or damage' to investor interests and detailed parameters for the same;
- (vi) it appoints separate fund manager for each separate fund managed by it unless the investment objectives and asset allocation are same and the portfolio is replicated across all the funds managed by the fund manager, within a period of six months from the date of notification of Securities and Exchange Board of India (Mutual Funds) (Amendment) Regulations, 2011;
- (vii) it ensures fair treatment of investors across different products that shall include, but not limited to, simultaneous buy and sell in the same equity security only through market mechanism and a written trade order management system; and
- (viii) it ensures independence to key personnel handling the relevant conflict of interest is provided through removal of direct link between remuneration to relevant asset management company personnel and revenues generated by that activity:

Provided further that the asset management company may, itself or through its subsidiaries, undertake portfolio management services and advisory services for other than broad based fund till further directions, as may be specified by the Board, subject to compliance with the following additional conditions:-

- (i) it satisfies the Board that key personnel of the asset management company, the system, back office, bank and securities accounts are segregated activity wise and there exist system to prohibit access to inside information of various activities;
- (ii) it meets with the capital adequacy requirements, if any, separately for each of such activities and obtain separate approval, if necessary under the relevant regulations.

Provided further that the asset management company may become a proprietary trading member for carrying out trades in the debt segment of a recognised stock exchange, on behalf of a mutual fund.

Explanation:—For the purpose of this regulation, the term 'broad based fund' shall mean the fund which has at least twenty investors and no single investor account for more than twenty five percent of corpus of the fund."

Extract of regulation 5 of SEBI (Foreign Portfolio Investors) Regulations 2014

"Categories of foreign portfolio investor

5. An applicant shall seek registration as a foreign portfolio investor in one of the categories mentioned hereunder or any other category as may be specified by the Board from time to time:

(a) "Category I foreign portfolio investor" which shall include Government and Government related investors such as central banks, Governmental agencies, sovereign wealth funds and international or multilateral organizations or agencies;

(b) "Category II foreign portfolio investor" which shall include:

(i) appropriately regulated broad based funds such as mutual funds, investment trusts, insurance/reinsurance companies;

(ii) appropriately regulated persons such as banks, asset management companies, investment managers/ advisors, portfolio managers;

(iii) broad based funds that are not appropriately regulated but whose investment manager is appropriately regulated:

Provided that the investment manager of such broad based fund is itself registered as Category II foreign portfolio investor:

Provided further that the investment manager undertakes that it shall be responsible and liable for all acts of commission and omission of all its underlying broad based funds and other deeds and things done by such broad based funds under these regulations.

(iv) university funds and pension funds; and

(v) university related endowments already registered with the Board as foreign institutional investors or sub-accounts.

Explanation 1.- For the purposes of this clause, an applicant seeking registration as a foreign portfolio investor shall be considered to be "appropriately regulated" if it is regulated or supervised by the securities market regulator or the banking regulator of the concerned foreign jurisdiction, in the same capacity in which it proposes to make investments in India.

Explanation 2.-

A) For the purposes of this clause, "broad based fund" shall mean a fund, established or incorporated outside India, which has at least twenty investors, with no investor holding more than forty-nine per cent of the shares or units of the fund:

Provided that if the broad based fund has an institutional investor who holds more than forty nine per cent of the shares or units in the fund, then such institutional investor must itself be a broad based fund.

B) For the purpose of clause A of this Explanation, for ascertaining the number of investors in a fund, direct investors as well as underlying investors shall be considered.

C) For the purpose of clause B of this Explanation, only investors of entities which have been set up for the sole purpose of pooling funds and making investments, shall be considered for the purpose of determining underlying investors.



- (c) "Category III foreign portfolio investor" which shall include all others not eligible under Category I and II foreign portfolio investors such as endowments, charitable societies, charitable trusts, foundations, corporate bodies, trusts, individuals and family offices."
