INTERIM REPORT OF THE WORKING GROUP ON KNOW YOUR CLIENT REQUIREMENTS FOR FOREIGN PORTFOLIO INVESTORS

SEBI WORKING GROUP ON FPI REGULATIONS

INTERIM REPORT ON SEBI CIRCULAR OF APRIL 10, 2018 ON KYC REQUIREMENTS FOR FPIS

The SEBI Working Group ("Group") on Re-drafting of FPI Regulations, under the chairmanship of Shri H R Khan, was formed by SEBI in March 2018 and has representations from reputed Law firms, Tax firms, Custodians and SEBI officers. The initial brief for the Group was about reviewing and redrafting FPI regulations, FAQs and Operating Guidelines (OG) related to FPI registration and operations in India.

On April 10th 2018, SEBI issued a circular ("**April 10 Circular**") on KYC Requirements for FPIs and given the widespread discussions and debate the circular has generated on its likely implications for investments in in India through the FPI route, SEBI requested the Group to look into various aspects of the circular on priority basis and suggest changes, if and as, necessary to appropriately address the concerns and respond to the feedback received from various stakeholders like FPIs, Custodians, Asset Managers and the Asia Securities Industry & Financial Markets Association (ASIFMA) on the circular.

The group held wide consultations with various stakeholders on different dates. Officials of the Ministry of Finance (MOF) from the Department of Economic Affairs (DEA) and the Department of Revenue (DOR) were also consulted. The Group also met with some lawyers and industry representatives to receive their feedback and suggestions which were further deliberated by the Group.

The Group took note of April 10 Circular, which, inter-alia, implied using the definition of Beneficial Owners (BOs) under the PMLA Rules 2005 for determining the eligibility of Non Resident Indians (NRIs)/ Overseas Citizens of India (OCIs) participation in FPIs.

It was brought to the notice of the Group that the Department of Revenue (DOR), Government of India have since communicated to SEBI that the principle laid down in Rule 9(3) of the Prevention of Money-laundering (Maintenance of Records) Rules 2005 is for the purpose of customer due diligence and need not apply *mutatis mutandi*s to determine the eligibility for of foreign investors as FPIs. It also, *inter-alia*, stated that there was no legal compulsion for SEBI to adopt the definition of Beneficial Owner in Rule 9(3) of PMLA Rules, 2005 for eligibility purposes.

This is broadly in line with the thinking of the Group that the BO criteria under PMLA may be made applicable only for the purpose of KYC and not as eligibility criteria for FPIs, including those having NRIs/OCIs/ Resident Indians (RIs) as their constituents. Likewise, the Group is also of the view that clubbing of investment limit for FPIs need not be done on the basis of BO as per PMLA. Accordingly, the Group considered separate set of

norms for determining the eligibility conditions where NRIs/OCIs/RIs are constituents of FPIs and also the basis for clubbing of investment limits.

Post the wide spread consultations and deliberations, the Group has come up with following recommendations with regard to the April 10 Circular and these have been grouped under four sections relating to:

A. Non-Resident Indians (NRIs)/ Overseas Citizens of India (OCIs)/ Resident Indians (RIs)

B. Clubbing of Investment limit

C. Identification and verification of Beneficial Owners

D. Other aspects

Section A: Recommendations relating to NRIs / OCIs / RIs

1. Eligibility conditions where NRIs/OCIs/RIs are constituents of FPIs

Regime prior to the April 10 Circular: Entities owned by Non-Resident Indians (NRIs)/ Resident Indians (RIs) could be registered as non-investing FPIs for the purpose of acting as an investment manager for other FPIs (i.e. investing FPIs). In the answers given to questions numbers 91, 114 and 127 in the FAQs on FPI Regulations, 2014 issued by SEBI, it was clarified that entities owned by NRIs / Persons of Indian Origin (PIOs) are specifically permitted to act as investment managers with the condition that such entities would not be allowed to make investments on behalf of self.

Condition imposed by the April 10 circular: The April 10 circular clarifies that NRIs, OCIs and RIs cannot be beneficial owners (BOs) of investing FPIs. According to the circular, BO should be identified in accordance with Rule 9 of the Prevention of Money-laundering (Maintenance of Records), Rules, 2005 (hereinafter referred as PMLA Rules). It has been explained to the group that drawing from the definition of BO given in Rule 9 of PMLA Rules, it was felt that since NRIs and RIs are prohibited from becoming FPIs in accordance with Regulations 4(a) and 4(e) of the SEBI FPI Regulations, the same should also not be permitted indirectly by becoming BOs of FPIs.

Recommendation:

It was brought to the notice of the Group that the Department of Revenue (DOR), Government of India have since communicated to SEBI that the principle laid down in Rule 9(3) of the Prevention of Money-laundering (Maintenance of Records) Rules 2005 is for the purpose of customer due diligence and need not apply *mutatis mutandis* to determine the eligibility for of foreign investors as FPIs. It also, inter-alia, stated that there was no legal compulsion for SEBI to adopt the definition of Beneficial Owner in Rule 9(3) of PMLA Rules, 2005 for eligibility purposes.

This is broadly in line with the thinking of the Group that the BO criteria under PMLA may be made applicable only for the purpose of KYC and not as eligibility criteria for FPIs, including those having NRIs/OCIs/ Resident Indians (RIs) as their constituents. Accordingly, the Group has considered separate set of norms for determining the eligibility conditions where NRIs/OCIs/RIs are constituents of FPIs.

The Group recommends that NRIs/OCIs/RIs may be allowed to be constituents of FPIs subject to the following conditions:

i. Single NRI/ OCI/ RI holding is below 25% of the Assets Under Management (AUM) in the FPI

ii. Aggregate NRI/ OCI/ RI holdings is below 50% of Assets Under Management (AUM) in the FPI

iii. NRI/ OCI/ RI should not be in Control of an FPI. However, there should be no restriction on NRIs / OCIs / RIs investment managers to be in control of the FPI provided any of the following conditions is satisfied:

a) The investment manager entity of the FPI is appropriately regulated in its home jurisdiction and registers itself with SEBI as a non-investing FPI, or

b) The investment manager is incorporated or setup under Indian laws and appropriately registered with SEBI, or

c) Where such FPIs are 'offshore funds' as approved by SEBI

Explanation:

Investment manager would mean an entity performing the role of investment management, investment advisory or any equivalent role, including trustees.

Control includes the right to appoint majority of the 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.

Existing FPIs not in conformity with the above requirements may be allowed reasonable time to take appropriate actions to comply with the conditions.

Many FPIs are open-ended funds and due to reasons such as redemption by existing investors, portfolio rebalancing etc., it is possible that ownership or entitlement of a RI / NRI / OCI may temporarily cross the eligibility conditions (as recommended at (i) and (ii) above).

The Group recommends that in case of such temporary breaches, FPI may be provided 90 days to comply with above eligibility condition/s. In case the FPI remains non-compliant with this requirement after 90 days, no fresh purchases may be permitted and it may have to liquidate its existing position in Indian securities market in the next 180 days.

In the April 10 circular, it has been stated that in accordance with Rule 9 of PMLA Rules, in a case where no BO is identified based on controlling ownership interest or control criteria, the SMO of the FPI would be regarded as the BO. In such cases, an NRI/OCI/RI would not be allowed to be SMO of FPI as per the Circular. According to the Group, as mentioned above, the BO criteria under PMLA may be made applicable only for the purpose of KYC. Accordingly, the Group also recommends that there should be no restriction on NRI / OCI / RI to be the SMO of a FPI.

2. PIOs not to be subject to restrictions imposed by the April 10 Circular

Regime prior to the April 10 Circular: In the FAQs issued on SEBI FPI Regulations, 2014, PIOs have been subjected to the same restrictions as applicable to NRIs.

Restrictions imposed by the April 10 Circular**:** The April 10 Circular imposes restrictions only on NRIs, OCIs and RIs, there is no specific reference to the Persons of Indian Origin (PIOs) in the April 10 Circular. However, since the FAQs are still valid and the fact that the definition of NRIs under the Income Tax Act, 1961 includes PIOs as well, there is a confusion whether the restrictions imposed by the April 10 Circular on NRIs / OCIs / RIs would be applicable to PIOs as well.

Recommendation:

The Group deliberated whether we could consider limiting the eligibility conditions only to NRIs since OCI status may be used by PIOs not necessarily for availing of any benefit from an investment purposes but also for other benefits such as ease of immigration. However, since the definition of NRI under FEMA 20 includes OCIs, it was felt that current restrictions may be imposed upon NRIs and OCIs only and it may be clarified that PIOs (without OCI status) should be excluded from the applicability of the restriction under April 10 Circular.

Further, “PIO” as a concept has been done away with in the Foreign Exchange Management Act (FEMA). It is recommended that no restrictions may be placed on the erstwhile Persons of Indian Origin (PIOs) and the relevant FAQs answered earlier may be superseded.

The Group also suggested that suitable definition of NRI and OCI may be included in FPI Regulations.

SECTION B:

3. Recommendation relating to clubbing of investment limit of FPIs having Common ownership or control

Regime prior to the April 10 Circular: Clubbing of investment limit for FPIs was on the basis of common ownership or control of more than 50 percent, as mentioned in Operational Guidelines for Designated Depository Participants.

Conditions imposed by the April 10 Circular: In terms of paragraph 2(a)(vi) of the April 10 Circular, clubbing of investment limit for FPIs is on the basis of Beneficial Ownership (as per PMLA Rules) of FPIs. This effectively means that the current clubbing provisions will also be applicable where BOs are identified on the basis of Control/SMO.

Recommendation:

a) As mentioned above, the BO criteria under PMLA may be made applicable only for the purpose of KYC and not for clubbing of investment limits.

b) Clubbing of investment limit for FPIs may be on the basis of common ownership i.e. all entities having direct or indirect common shareholding / beneficial interest, of more than 50% OR based on common control (as defined under explanation to para 1 above).

c) Clubbing of investment limit of FPIs having common control may not be applicable in any of the following cases where:

   (i) FPIs are appropriately regulated public retail funds or

   (ii) FPIs are appropriately regulated public retail funds majority owned by public retail fund on look through basis or

   (iii) FPIs are public retail funds and investment managers (IMs) of such FPIs are appropriately regulated.

d) Public retail fund would generally mean (i) mutual funds or unit trusts which are open for subscription to retail investors and do not have specific investor type requirements e.g. accredited investors etc, (ii) insurance companies where segregated portfolio with one to one correlation with a single investor is not maintained and (iii) pension funds.

e) In order to appropriately monitor investment concentration where common control is identified for such public retail fund, Indian depositories will maintain details of controlling entities on the basis of name, nationality, passport number/ national ID etc. and provide appropriate reports to SEBI on periodic basis.

f) Clubbing of investment limit of FPIs having common control identified on the basis of “SMO” may not be made applicable.

g) Investment manager would mean an entity performing the role of investment management, investment advisory or any equivalent role.

SEBI may consider making suitable changes in FPI Regulations.

SECTION C: Recommendations on identification and verification of Beneficial Owners

4. Need to bring uniformity of requirement across all Category I FPIs

Regime prior to the April 10 Circular: All Category I FPIs were exempted from submitting beneficial ownership list, proof of identify and address documents for senior managing officials, authorized signatories and beneficial owners ("**BOs**").

New norms under the April 10 Circular**:** In paragraph 2(a)(iv) of the April 10 Circular, if any FPI is coming from a "high risk jurisdiction", the intermediary (DDP) is required to apply a lower materiality threshold of 10% for identification of BO of such FPI and ensure that KYC documentation as applicable for category III FPIs is obtained from such FPIs. The April 10 Circular does not specifically exempt category I FPIs coming from "high risk jurisdiction" from meeting such lower materiality threshold and category III FPI KYC documentation requirements.

Recommendation:

a) Category I FPIs are either government/government related entities and are perceived to be low risk entities. Considering the same, it is recommended that Category I FPIs coming from all jurisdictions be exempt from:

   i. Providing additional KYC documentation requirements as applicable to Category III FPIs, including BO declaration.

   ii. Providing declaration related to issuance of bearer shares considering that majority shareholding of such Category I FPIs is with the Government.

b) KYC review of Category I FPIs should be done at the time of continuance of their FPI registration.

c) For the purpose of KYC requirements, an entity would be considered to be a 'foreign government agency' only if more than 75% ownership entitlement and control is held by the Government of a foreign country [(including FPIs from non-high risk jurisdiction)]. This will ensure that no other significant shareholder is able to participate.

5. Definition of Senior Managing Official

Regime prior to the April 10 Circular: The term senior managing official ("**SMO**") was not defined under the FPI Regulations and/or the PML Act or rules issued thereunder.

Conditions imposed by the April 10 Circular: In paragraph 2(a)(vi) of the April 10 Circular, it has been provided that where no material shareholder/owner entity is

identified in the FPI using the materiality threshold (for controlling ownership interest basis and also on control basis (for companies and trusts), BO shall be the SMO of the FPI.

Recommendation: In absence of clear definition, the term SMO could be subject to different interpretations resulting in inconsistent approaches. Hence, Group recommends below definition of the term:

"*The term senior managing official (SMO) means an individual as designated by the FPI who holds a senior management position and makes key decisions relating to the FPI."*

6. Identification of BO of listed entities

Regime prior to the April 10 Circular: Rule 9(3)(f) of the PMLA Rules provides that "where the client or the owner of the controlling interest is a company listed on a stock exchange, or is a subsidiary of such a company, it is not necessary to identify and verify the identity of any shareholder or beneficial owner of such companies".

Requirement under the April 10 Circular**:** The April 10 Circular requires all FPIs to identify and verify its BO, and does not specifically provide any exemption from meeting such requirement if the FPI or its holding company or controlling interest owner is a company listed on a stock exchange. In the absence of any specific guidance in relation to listed entities in the April 10 Circular, and paragraph 2(a)(i) of the April 10 Circular providing that BO should be identified in accordance with Rule 9 of the PMLA Rules, there could be inconsistent views be taken by the market on whether BO is required to be identified if the FPI or its holding company or controlling interest owner is a company listed on a stock exchange.

Recommendation: It is suggested that SEBI may specifically clarify that exemption under Rule 9(3)(f) of the PMLA Rules is only available to an FPI or its BO which is a company listed on a stock exchange in following kinds of jurisdictions and such stock exchange is recognized and supervised by its home regulators:

a. a country whose securities market regulator is a signatory to International Organization of Securities Commission's Multilateral Memorandum of Understanding (Appendix A Signatories) or a signatory to bilateral Memorandum of Understanding with SEBI, or

b. a country which is not identified in the public statement of Financial Action Task Force as

(i) a jurisdiction having a strategic Anti-Money Laundering or Combating the Financing of Terrorism deficiencies to which counter measures apply; or

(ii) a jurisdiction that has not made sufficient progress in addressing the deficiencies or has not committed to an action plan developed with the Financial Action Task Force to address the deficiencies.

7. BO declaration for partnerships on control basis

The PMLA Rules as well as the April 10 Circular provides that BOs in case of partnership firms are required to be identified on ownership or entitlement basis. Neither the PMLA Rules, nor the April 10 Circular, requires partnership firms to identify BOs on a control basis. Considering general partners (GPs) in an offshore partnership structure are typically in control of the partnership (LP), the Group recommends it may be clarified that such BO declaration on control basis is not required for a GP/LP structure or otherwise.

Recommendation: In case the view is taken that partnership firm set up as General Partner/Limited Partnership is required to identify BO on control basis then appropriate changes may be made in KYC requirements.

SECTION D: Other Aspects

8. Timelines for compliance:

The remediation based on the KYC circular is going to be an extensive exercise given large number of FPIs in the market, Global custodian (GC) structure and a revised KYC circular may have to be issued based on recommendations of this Group and other feedbacks received by SEBI. Based on above, we recommend SEBI to allow 6 months time from the time the revised circular is published for appropriate compliance with the new requirements.

9. Applicability of April 10 circular to FPI investment through Offshore Derivative Instrument (ODI)

Some questions were raised on applicability of the KYC circular on FPI investments through ODIs. In order to bring clarity on applicability of April 10 circular, it may be clarified that the compliance requirement is also applicable to ODI subscribers.

10. Impact of FPIs not meeting the stipulations of KYC circular

To provide clarity on impact of non-compliance with the KYC circular on FPIs, it is recommended that:

If an FPI fails to comply with the applicable KYC requirements by the given deadline, the concerned Custodian shall not allow such FPI to make fresh purchases till the time KYC documentary requirements, as applicable, are complied with. However, such FPI shall be allowed to continue to sell the securities already purchased by it.

Such FPI shall be allowed to disinvest its holdings within a period of 180 days from the expiry of the timeline permitted by SEBI.

In case FPI remains non-compliant with this requirement even after 180 days from the said deadline, its FPI registration will no longer be valid and it would need to disinvest its holdings immediately.

11. Disclosure of personal information:

Regime prior to the April 10 Circular: Personal information (birthdate/ address/ID number) were not required to be disclosed as per BO format.

Conditions imposed by the recent circular: In the current BO details format personal information (birthdate/ address/ID number) must be disclosed for Category II FPIs.

Recommendation:

It was recommended that social security number in the last column in the BO table may also mean equivalent national ID number and SEBI may formulate a suitable policy for sharing of personal information of the BOs.

12. Requirement of intermediate entities where no natural person as BO is identified based on ownership or entitlement or control:

Regime prior to the April 10 Circular: No requirement to provide details of intermediate entities holding above material threshold and only natural person details was mandatory.

Conditions imposed by the April 10 Circular: Point 2(a)(v) of current circular the materiality threshold (referred at (iii) & (iv) above) to identify the beneficial owner should be first applied at the level of FPI and next look through principle shall be applied to identify the beneficial owner of the material shareholder/ owner entity. Only beneficial owner with holdings equal & above the materiality thresholds in the FPI need to be identified through the aforesaid look through principle.

Recommendation: SEBI may clarify where no natural person is identified based on ownership or entitlement or control, whether details of intermediate entities holding above material threshold are not required or otherwise.

In case the view is taken that beneficial owner and material shareholder/ owner entity with holdings equal & above the materiality thresholds in the FPI need to be identified through the look through principle and for intermediate material shareholder/ owner entity/ies, name and percentage holding shall be disclosed, SEBI may clarify by appropriately amending its circular.

13. Other issues:

The group is also examining separately whether any recommendations to merge the FPI and NRI/OCI routes of investment can be made to Government of India and Reserve Bank of India. The group also recommended that SEBI may suitably clarify actions to be taken by FPIs for divestment or re-classification of holdings as FDI in case of breach of investment limits, after consulting Reserve Bank of India. The group also recommends that SEBI may consult Government of India to evolve more objective criteria for defining High Risk Jurisdictions.

The Group suggests that the recommendations contained in this Interim Report should be put in public domain for comments/ feedback from other stakeholders before SEBI takes final view in the matter.