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SEBI seeks addl info from FIIs: How do experts view it?

Yesterday, there was an important circular from SEBI (Securities and Exchange Board of India) seeking additional information on FII (Foreign Institutional Investor) structures. SEBI has asked FIIs apparently to stop using complex structures of protected cell companies (PCCs) and segregated portfolio companies (SPCs).

What impact or implications could it have on FIIs' running money in India? In an exclusive interview with CNBC-TV18, Siddartha Shah, Nishith Desai Associates and Gautam Mehra, ED, PwC, debate that.

Below is a verbatim transcript of the exclusive interview on CNBC-TV18. Also watch the accompanying video.

Q: Would it require significant amending of structures from existing FIIs operating in India?

Shah: I think it definitely would have an impact on some of the existing structures which were designed to allow such segregated portfolios with SEBI now formalising its position on PCCs or SPCs. I think more importantly the multi-class vehicles which is more worrying from an industry perspective. This could probably trigger off some amount of need for restructuring at the FII or the subaccount level to that extent.

I think the development on protected cell company is something which is formalising what always was regarded by SEBI as a restricted structure, so this is the first time they have come out with a specific undertaking in this regard. But practically they were always uncomfortable in granting registrations for these PCCs or SPCs. But the multi-class was slightly unexpected and may prove to be a bigger blow to the industry from a flexibility perspective.

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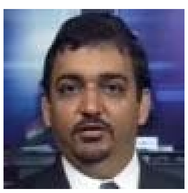
Q: Just to flesh the entire issue out a bit though, what is it that SEBI is getting at? Why is it that they want to see a change? What is the difference when we are talking about a common portfolio versus a segregated portfolio for the FIIs?



Mehra: There is a lot of jargon over here which would be unfamiliar to people who don't operate in this territory, PCCs and SPCs. We are talking about FIIs, coincidently the central word happens to be the institutional and keeping in line with that, SEBI has permit institutions such as mutual funds, insurance companies, pension funds to be eligible for the FII registration. Additionally, there are also permit asset managers and other groups to be entitled to this registration provided that they are broad based. Broad based has been defined to me in a minimum of 20 investors. That is the backdrop.

What is the change happening now? We have these PCCs and the multishare class vehicles which is essentially corporate entities where you have different classes of shareholders and each class of shareholders being entitled to let us say the rewards and returns on a particular portion of the portfolio owned by the own company rather than being entitled to share in the entire portfolio.

So why this broad base condition of 20 investors was always being looked at the shareholder level? I guess the fundamental shift is that that satisfaction of the condition needs to be done with respect to each portfolio which is shared by a group of investors. So that is the fundamental difference, which is ought to be made. I guess it is more realignment of what would have been the intention with the letter of the law now.

Q: I guess the fear at the back of the mind is whether this realignment leads to even some kind of short-term change or squeeze in terms of investment by these FIIs, do you see that happening or do you just see this as a longer process that needs to be covered now?

Shah: I think as I mentioned one is that the alignment of the policy with the practices and to that extent at least the PCC structure I can more easily relate to. But the position taken by SEBI on the multi-class vehicles, I think it is going to create some amount of issues for these structures which were designed around that.

If you look at it globally today, there maybe specific commercial needs why these segregated cells are needed or multi-class structure is needed. To that extent cutting down on such flexibilities for international players, just to give you an example there maybe family offices who maybe comfortable coming in to a multi-class structure as long as their portfolio is segregated, to that extent I think India being one of the destination where these global players can invest.

Taking away this flexibility, I think it creates unnecessary hindrance for the flow of capital. I think this could possibly create some amount of issues for the players already operating these structures and going forward also making it difficult for some of these players like managed accounts and others to operate in the Indian market place.

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Q: Just want you to explain this multi-class share vehicle in a bit of details with an example because that is the one point which you keep coming back to which could cause some kind of a discomfort?

Shah: I think sometime in early 2000 where SEBI at that point did not have any hard position on PCCs or multi-class structures, globally there are structures where PCCs where essentially each cell can have its own assets and liabilities which are statutorily ringfenced from the assets of the other cells and this obviously affords more protection for investors who are in a particular cell. Now, SEBI obviously for whatever reason in part of their investigation recognised that there were involvement of some of these PCCs during the stock market scam and they came up with the policy that they will not allow PCCs.

In the alternate, multi-class structures, those statutorily do not provide the same segregation of liability vis-à-vis third parties offered that flexibility that I could create either a specific portfolio for each cell or I could have for each investor a separate class of shares where intersay between the shareholders you can have the same amount of segregation which you would have otherwise head in case of a PCC structure.

This is something which is at times necessary where some of the investors as I said like family offices or even hedge funds or endowments to that extent want their portfolios to be segregated from the general portfolios and more so after what we saw in 2009. I think there was more demand for such segregated portfolios. So to that extent today, I think at an entity level as long as I was fulfilling the broad based, so if I had multiple share classes and as long as I had 20 investors on a look-through basis, I would have fulfilled the broad based criteria and those structures were eligible for registration with SEBI. With this change what SEBI has now done that if you do have multi-class structures, you may still be eligible provided each of your share-class should fulfill a broad based test which means that I can do it for different strategies, I can have different cells, but each of these strategies will have to be broad based in its own right.

As against that if I have investor wise share class and I was fulfilling that at an entity level, those structures will now not be eligible because I cannot have differentiated portfolios for each investors. So if I buy a stock, I have to proportionately allocate across all share classes. That is what SEBI has now made it mandatory under this new change that either you be broad based or have a proportionate portfolio across all your share-classes.

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Q: Is the eventual aim to arrive at more disclosures and more transparency for the people investing into this country and could that lead to some discomfort amongst the eventual investors?

Mehra: I guess transparency would be one of the objectives, but as I said earlier, probably the intention seems to be that to permit FII registrations to broad based funds. When they mean broad based funds, they mean at least 20 investors sharing in the returns of a particular portfolio and that is where the whole thing is headed.

I will come back to what I stated at the beginning that this whole criteria of broad based fund so to say is not a criteria to be fulfilled by institutional investors like mutual funds or pension funds. They are by inherent nature broad based, so it is more as Mr Shah also mentioned for a family office wanting to come in and invest through a share-class. So I guess it is more about broad basing investors in true spirit and in line with the intention rather than ticking the box at the entity levels.