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Wary of round-tripping, SEBI blocks 50 investors

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MUMBAI: The Indian capital market regulator has shut its doors on several foreign funds amid concerns that they may turn out to be vehicles for round-tripping of money by local residents. The Securities and Exchange board of India (Sebi) is taking a closer look at the structure of new investors, as well as those seeking renewals, following misreporting of transactions by blue-chip foreign institutional investors (FIIs) like Barclays and Societe Generale (SocGen).

According to senior fund advisors and officials of custodian banks, SEBI, the market watchdog, has put on hold registration of close to 50 investors who are organised as 'multi-class share entities' in tax havens like Mauritius. Similar to a mutual fund, a multi-class structure allows distinct pools of investments, just like the various schemes of a MF, under an umbrella asset management company. The investors putting money in the various pools, which are referred to as cells by market participants, can have different fund managers pursuing different investment strategies.

The fear is that while the umbrella firm gets registered as an FII or a sub account, a special purpose vehicle formed in Mauritius to access Indian stock exchanges, the regulator may have no control over the different pools or cells under the firm. And, once a multi-class share entity gets registration, it can go on adding new cells which, outside the regulatory radar, can be the conduits for round-tripping. Significantly, Pluri, the entity which surfaced in the Barclays and SocGen cases, was a multi-class entity incorporated as a "protected cell company" in Mauritius.

The two European banks were hauled up by SEBI for concealing the fact that Participatory Notes (PNs) issued to an overseas entity, Hythe Securities, were then onward issued to Pluri Emerging Companies. PNs are notes that enable offshore investors to trade Indian stocks.

In both cases, the PNs had Reliance Communications stock as the underlying. "It appears that there is a policy level review at SEBI as far as multiclass entities are concerned. For several years, such entities have been in existence and SEBI has granted sub account/FII registrations to such entities upon them fulfilling the broad based test at the entity level. The reason for such rethink is unclear," said Siddharth Shah, head-funds practice, Nishith Desai Associates.

What, however, is evident is that post Pluri, SEBI is in two minds on the kind of entities that may be allowed to come in as an FII or a sub-account. "SEBI has asked entities which have applied for sub-account registration on whether they are registered as a multi-class share firm or a Protected Cell Company (PCC) in Mauritius," said a senior official with a foreign custodian bank.

So far, SEBI has neither spelt out the exact nature of Pluri's dealings nor disclosed the investors in the various cells of Pluri. But it is clear that SEBI does not want a multi-cell sub-account to operate like Pluri. Industry officials involved with the FII registration process said that the regulator has possibly spotted entities involved in round-tripping transactions.

A multi-class entity or a PCC can be formed in such a way that one cell may have just two to three investors, even though the total number of investors, taking into account all the cells, may be well over 20, the minimum number of investors required for a broadbased sub-account. SEBI, it's understood, wants the cells in a multi-class entity to operate as broad-based sub-accounts, where the fund manager is answerable to multiple investors. But, if a cell has just one or two dominant investors, the latter are in a position to influence trading.

"This move of SEBI will enable appropriate delinking and monitoring of portfolio related compliance as well as investor liability issues," said Punit Shah, who specialises in rendering tax and regulatory services to financial services organisations. But according to Siddharth Shah, many of whose clients are awaiting renewals and registrations.

"SEBI has, in the past, with no valid concerns, has banned protected cell company structures, a very popular structure globally for funds wishing to segregate assets and liabilities for each cell dedicated to different strategies or investors - from being eligible to register as FII or sub account.

The suspension of registration of multi class entities will only make life for India-focussed funds even more difficult and push many away from direct registrations to PNs ...This would be counter productive to SEBI's overall intent of encouraging direct access over PNs." Even though SEBI had banned PCC structures in '99-00, foreign investors can set up multi-class structures which, as legal entities, are a little different from PCCs.

The similarity between the two is that each cell has separate accounts and losses suffered by one pool cannot be recovered from another. The key difference is: in a PCC, each cell is legally ringfenced and bankruptcy faced by one cell will not impact the other cells; but in a multi-class share entity anyone suing a cell has to sue the entire company not the shareclass. But, due to the similarity in their basic structure, a multi-class share entity can be misused in the same way as a PCC, feels the regulator.

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