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New FII investment norms may separate the good and the bad

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SEBI plans to curb potential round-tripping through FIIs and also increase transparency. If successfully implemented, the move will segregate the opportunistic short-term investors from the committed long-term ones

Market regulator Securities and Exchange Board of India (SEBI) has asked all foreign institutional investors (FIIs) not to follow a protected cell company (PCC) or segregated portfolio company (SPC) structure.

A PCC or SPC is an entity with several cells within the same fund vehicle that may represent distinct investment objectives. A cell within the PCC or SPC has its own assets and liabilities as well as capital, dividends and accounts. This helps the fund manager to market a single fund which can have different investment plans for different investors.

"The FII has to declare that it is not a protected cell company (PCC) or segregated portfolio company (SPC) and doesn't have an equivalent structure," SEBI said in a circular. FIIs have also been directed to declare that they are not a multi-class share vehicle (MCV) by constitution and do not have an equivalent structure. FIIs have to declare that their investment contains only single-class shares instead of MCVs, the market regulator said.

PCCs or SPCs are commonly used in the formation of collective investment schemes as umbrella funds and for the formation of cap ive insurance companies. They are also sometimes used as asset-holding vehicles, characteristically where each portfolio holds a single ship or aircraft, and they can also potentially be used in capital market debt issuances.

"While we understand the regulators' concerns about round-tripping and money laundering by Indian residents, we believe that a blindfolded blanket ban on FIIs and genuine investors may not be the correct remedy. We believe that money laundering and round-tripping for tax evasion issues should be rather checked by stronger and robust exchange controls," said law firm Nishith Desai Associates, in a report.

Despite satisfying the broad-based fund criteria at the entity level, the fund vehicle has flexibility to pursue dedicated investment strategies for identified investors. This goes against the essence of a broad-based fund, as the investment does not represent the interest of all the investors, but of specific investors as per their investment strategy.

Though SEBI has provided almost six months for the sunset provisions, it would jeopardise the structures of many existing FIIs and sub-accounts which were structured as MCVs or have a PCC or SPC in their group structure, the law firm added.

Because of the relative ease of forming multiple offshore companies in most jurisdictions where SPCs are available for incorporation, and because it is uncertain how the concept of segregated portfolios and thus no consequential cross-contamination of liabilities would be treated in an onshore bankruptcy or by credit ratings agencies, many promoters still instead opt for the formation of multiple companies under a single holding company.

Similarly, the market regulator had expressed concerns for fund vehicles structured as MCVs, adding new classes of shares or sub-funds after seeking registration as a sub-account. SEBI said that FIIs declaring that they were not MCVs would need to ensure that they had only one category of investors, also referred to as single class of shares.

Typically, MCVs are used in two ways. The first option is to have a common portfolio that has at least 20 investors at the FII level. The second option is to have a segregated portfolio for each class of investors, where each class must have a minimum of 20 investors. SEBI has asked FIIs that were registered before 7th April to comply with the norms by September end.

"In today's global scenario, apart from the developing economies, India stands to compete with the developed Western markets also for foreign inflow of capital. Therefore, it is impera ive that the Indian regulators ensure that genuine foreign investments are not hindered due to an adverse regulatory regime, which may lead to diversion of India-dedicated funds to other economies," added Nishith Desai Associates. However, unless it is clear how much of investment is due to round-tripping, it is impossible to say whether he new rules would be a hindrance. After all, a lot of genuine long-term investors don't use the PCC or SPC structure.