

Regulatory Hotline

May 23, 2023

SEBI DIRECTS DESIGNATED DEPOSITORY PARTICIPANTS TO IDENTIFY 'LEGAL ENTITIES' FOR FOREIGN PORTFOLIO INVESTORS

INTRODUCTION

The Indian securities market regulator, Securities and Exchange Board of India (“SEBI”) has lately been taking numerous steps to regulate and monitor the activities of Foreign Portfolio Investors (“FPIs”) registered with SEBI under the SEBI (Foreign Portfolio Investors) Regulations, 2019 (“FPI Regulations”), including their beneficial ownership.

In the most recent of such developments, SEBI, vide an e-mail to the Designated Depository Participants (“DDPs”), has communicated certain client identification, know your customer (“KYC”) and beneficial ownership requirements for the FPIs. Interestingly, no circular / guideline / direction has been released by SEBI in this regard in the public domain.

THE SEBI DIRECTIVE

Identification of clients

SEBI has mandated that only a legal entity should become client of a DDP (i.e., in its capacity of a reporting entity under the Prevention of Money-Laundering Act, 2002). Thus, a bank and not its branch which may be registered as an FPI with SEBI, or an entity and not its sub-funds investing in India as FPIs, should be the client of the DDPs. However, such legal entities should be able to obtain multiple FPI registrations in the name of their funds / sub-funds.

The Prevention of Money-Laundering Act, 2002 (“PMLA”) defines the term ‘client’ as ‘a person who is engaged in a financial transaction or activity with a reporting entity and *includes a person on whose behalf the person who engaged in the transaction or activity, is acting*¹. Thus, the requirement of identification of the legal entity as the client of the DDP seems to stem from the above definition.

Moreover, such legal entity shall also be required to furnish the requisitioned KYC information and supporting documents to the DDP.

Identification of Senior Management Official as the BO of FPI

The rules for the identification and verification of a beneficial owner (“BO”)² of a client are laid down in the Prevention of Money-laundering (Maintenance of Records) Rules, 2005 (“PML Rules”), which mandate a reporting entity to, inter alia, identify its client and verify its identity.

Rule 9(3)(d) of the PML Rules provides that if no BO (through ownership or control) can be identified in case of a client set up as a company, partnership firm or an unincorporated association or body of individuals, then the BO is the relevant natural person who holds the position of senior managing official (“SMO”).

SEBI, in this regard, has directed the DDPs to identify and declare the SMO of the legal entity at the end of the chain of the legal arrangement, as the BO of the FPI.

Identification of BO as per new threshold

On March 07, 2023, the Department of Revenue, Ministry of Finance, Government of India amended the PML Rules and notified the Prevention of Money-laundering (Maintenance of Records) Amendment Rules, 2023 (the “Amendment Rules”). The Amendment Rules inter alia amended the ownership threshold for the identification of BO under the PML Rules to (i) 10% for companies and trusts; and (b) 15% for partnership firms and unincorporated association or body of individuals. Please see our hotline “Amendment to Anti-Money Laundering Laws: A Relative Conundrum” for an analysis of the Amendment Rules and their effect on FPIs.

SEBI, in its email communication, has asked all the existing FPIs to re-identify and disclose the BO(s) to their DDPs as per the new thresholds.

Prescribed Timeline

The DDPs have been asked to complete the KYC at the legal entity level and update BO data, as per reduced threshold, if required, in their records as well as on the KYC Registration Agency portal by September 30, 2023.

In case the FPI fails to make the requisite disclosures within the above-mentioned timeline, then such FPI shall not be permitted to make fresh purchases and shall be required to liquidate its holdings and surrender the registration by March 31, 2024.

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This informal directive of SEBI seems to be another step towards filling the lacunae in the identification and verification process of FPIs. While on one hand, this regulator activism needs to be appreciated since it should ultimately increase transparency in the entire ecosystem and help the Indian securities market to further flourish, on the other hand, such frequent legal changes and email communications may end up hampering the peace of the genuine investors and may prove to be counterproductive.

We believe that SEBI's objective towards identifying the legal entity as the client of the DDP aims at ensuring that the actual entity duly regulated by the appropriate regulator of the home jurisdiction is disclosed to the DDP.

Further, while it is helpful to finally receive clarity on which FPIs are required to re-identify the BOs basis new thresholds, disclosure of the SMO of the end entity seems irrational and not-well-thought-of.

Lastly, this method of communication by SEBI is also not well appreciated. Considering that these are crucial directives for the FPI players, a circular / guideline by SEBI issued in the public domain in this regard, along with any standard declaration template(s) would have been much preferable.

– **Prakhar Dua & Kishore Joshi**

You can direct your queries or comments to the authors

¹Section 2 (1) (ha) of PMLA.

²The term 'beneficial owner' is defined under section 2(1)(fa) of the PMLA as 'an individual who ultimately owns or controls a client of a reporting entity or the person on whose behalf a transaction is being conducted and includes a person who exercises ultimate effective control over a juridical person'.

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September 22, 2024