

Regulatory Digest

January 31, 2024

REGULATORY WRAP 2023: DEVELOPMENTS IN FOREIGN PORTFOLIO INVESTOR REGIME IN INDIA

The whole of 2023 was a watershed year for Foreign Portfolio Investors ("FPIs") in India. With the Indian securities market regulator, the Securities and Exchange Board of India ("SEBI") being on its toes since the Hindenburg fiasco in January last year, the regulations governing FPIs in India have undergone major changes. Over the past year, SEBI has issued multiple circulars amending / updating the regulatory regime governing FPIs and has had numerous correspondences with Designated Depository Participants ("DDPs") in relation to the different information required from FPIs. SEBI has also brought about amendments to the SEBI (Foreign Portfolio Investors) Regulations, 2029 ("FPI Regulations") and the Master Circular for FPIs, DDPs and Eligible Foreign Investors ("Master Circular").

As the curtain falls on 2023, we look at the changes brought about in the regulatory landscape governing FPIs in India.

IDENTIFICATION OF LEGAL ENTITIES OF FPIs

SEBI vide an e-mail communication to DDPs dated February 03, 2023, communicated certain client identification, know your customer and beneficial ownership requirements for FPIs.

The email stipulated that only a legal entity could become a client of DDP in its capacity as a reporting entity under the Prevention of Money-Laundering Act, 2002. Therefore, 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 can obtain multiple FPI registrations in the name of their funds / sub-funds. Interestingly, no circular / guideline / direction was released by SEBI on this subject in the public domain and SEBI only communicated with the DDPs through emails.

Please see our hotline [SEBI directs DDPs to identify 'Legal Entities' for FPIs](#) for an analysis of the above.

CHANGES IN THRESHOLD FOR IDENTIFYING BENEFICIAL OWNERS

The Government of India ("Government"), vide three amendments to the Prevention of Money-laundering (Maintenance of Records) Rules, 2005 ("PML Rules") brought about various changes to the rules related to anti-money laundering, including amendments to the thresholds for the identification of beneficial owners ("BO") of FPIs. The revised thresholds for identifying BOs by FPIs are provided below:

For Companies – Natural person(s), acting alone or together, through one or more juridical person having controlling interest or exercising control through other means on the company. In this regard, the definition of controlling interest has been amended to mean ownership or entitlement to more than ten percent of the shares or capital or profits of the company, and control includes the right to appoint majority of the directors or to control the management or policy decisions including by virtue of the shareholding or management rights or shareholders agreements or voting agreements.

For partnership firms - Natural person(s), who, whether acting along or together, or through one or more juridical person, has ownership of/entitlement to more than ten per cent of capital or profits of the partnership or who exercises control through other means.

For Trusts – The author of the trust, the trustee, the beneficiaries with ten per cent or more interest in the trust and any other natural person exercising ultimate effective control over the trust through a chain of control or ownership.

Please see our hotline [Amendment to Anti-Money Laundering Laws: A Relative Conundrum](#) for a detailed discussion on the change in BOs of Companies and Trusts.

CHANGES IN REPORTING TIMELINES

SEBI, vide the SBI (FPI) Amendment Regulations, 2023¹ dated March 14, 2023, amended the FPI Regulations, and *inter alia* reduced the timeline for reporting / intimation of material changes by FPIs to DDPs and by DDPs to SEBI. The March 27 Circular (defined below) amended the corresponding timelines in the Master Circular as well.

Please see our hotline [Intimation of material changes by Foreign Portfolio Investors: The Timeline Turbulence](#) for a detailed analysis of the above.

STREAMLINING OF FPI ONBOARDING

On March 27, 2023, SEBI introduced a circular² ("March 27 Circular") to facilitate ease of doing business and reduce the time taken for registration of FPIs in India. The Circular brought about changes in the Master Circular to include provisions enabling: (i) FPI registration based on scanned copies of the application forms and supporting documents,

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(ii) FPIs to use digital signatures, (iii) DDPs to rely on the digitally received and certified copies of FPI documents sent by authorized bank officials, (iv) verification of Permanent Account Number ("PAN") by DDPs, and (v) introduction of investor group ids for clubbing of investment limits for FPIs forming part of an investor group.

Please see our hotline [SEBI modifies FPI Master Circular: Onboarding Process Streamlined](#) for a detailed overview of the above change.

DIRECT MARKET ACCESS TO FPIs FOR PARTICIPATING IN EXCHANGE TRADED COMMODITY DERIVATIVES

SEBI, vide its circular dated May 10, 2023³ allowed stock exchanges to extend Direct Market Access ("DMA") facility to FPIs for participation in Exchange Traded Commodity Derivatives ("ETCDs") subject to the certain conditions.

This change allows FPIs to access the trading system of an exchange directly using the broker's infrastructure, enabling the placement and execution of orders without the broker's manual involvement. This also provides several benefits to FPIs, including direct order control, quicker order execution, decreased risk of errors linked to manual order entry, the preservation of confidentiality, reduced impact costs for substantial orders, and the implementation of more effective hedging and arbitrage strategies.

MANDATING LEGAL ENTITY IDENTIFIER FOR NON-INDIVIDUAL FPIs

On July 27, 2023, SEBI issued a circular⁴ mandating non-individual FPIs to provide their Legal Entity Identifier ("LEI") details. LEI is a 20-character code used to uniquely identify parties involved in financial transactions worldwide, enhancing the quality and accuracy of financial data systems. Pursuant to the issuance of the circular, all existing non-individual FPIs, who had previously not provided their LEI details to their DDP were mandated to provide the same within 180 days starting from July 27, 2023. Non-compliance with the requirement resulted in the accounts of such FPIs being blocked for further purchases until the LEI details are provided to the DDPs. Further, the circular mandated all non-individual FPI applicants to provide their LEI details in the Common Application Form ("CAF") at the time of making the application.

Prior to the issuance of the circular, the CAF provided an option to the applicants to provide their LEI details but, did not mandate the same. The circular directed DDPs to modify the CAF to make the LEI row as a mandatory one.

Moreover, the responsibility of maintaining an active LEI at all times lies with the FPIs. If an LEI expires or becomes invalid, a provision for blocking the FPIs' accounts from making further purchases in the securities market has been introduced. These accounts will remain blocked until the FPIs renew their LEI code.

TRANSACTIONS IN CORPORATE BONDS THROUGH REQUEST FOR QUOTE PLATFORM BY FPIs

Vide its circular dated August 7, 2023⁵, SEBI mandated FPIs trading in corporate bonds to undertake at least 10% of their total secondary market trades in corporate bonds by value by placing/ seeking quotes on the Request for Quote ("RFQ") platform of stock exchanges, on a quarterly basis. This has been introduced to increase liquidity of trading in corporate bonds on RFQ platform. This circular has been made effective from October 1, 2023.

ADDITIONAL DISCLOSURE BY FPIs FULFILLING CERTAIN OBJECTIVE CRITERIA

On August 24, 2023, SEBI released a circular (the "Disclosure Circular")⁶ mandating additional disclosures by certain objectively identified FPIs. The Disclosure Circular set forth the criteria under which certain FPIs would be required to furnish additional granular details of all entities holding any ownership, economic interest, or exercising control in the FPI, on a full look through basis, up to the level of all natural persons.

The Disclosure Circular also stipulated for a Standard Operating Procedure ("SOP") to be framed and adopted by all the DDPs/ Custodians, in consultation with SEBI. On October 20, 2023, the SOP was released by SEBI, and has since been amended thrice. However, the SOP has not been made publicly available on SEBI's website and is only available on the websites of certain DDPs / global custodians.

Issues raised in the Disclosure Circular

SEBI observed certain FPIs to be concentrating a substantial portion of their equity portfolio in a single investee company or corporate group for a long time and discussed the possible misuse of the FPI route by promoters and investors of listed entities for circumventing the minimum public shareholding ("MPS")⁷ requirement and manipulating the price of scrips.

On April 17, 2020, the Government issued Press Note No. 3 (2020 Series) ("PN3") with an objective to limit 'opportunistic' foreign direct investments ("FDI") from countries sharing land border with India ("Neighbouring Countries")⁸. The PN3 stipulated that where an investing entity is situated in a Neighbouring Country or where the beneficial owner of an investment into India is situated in or is a citizen of any such country, FDI would be permitted only with prior Government approval. While PN3 is not applicable to FPI investments, SEBI noted the potential misuse of the FPI route for circumventing the requirements of PN3. Further, the Disclosure Circular raised the concern of misuse of the FPI route by entities with large Indian equity portfolio for potentially disrupting the functioning of the Indian securities market.

The Disclosure Circular also highlighted the issue of identification of BO by FPIs. Even though the process for identification of BOs is laid down in the PML Rules, SEBI observed that in certain cases natural person(s) indirectly holding economic /ownership interest above the BO identification threshold were not identified as BO of the FPI entity since the interest was held through various investment entities, each of which individually fell below the threshold limit for identification as BO.

Applicability of the Granular Information requirement

The Disclosure Circular imposes certain granular disclosure requirements on the below categories of FPIs:

1. FPIs holding more than 50% of their Indian equity assets under management ("AUM") in a single Indian corporate group;

2. FPIs that individually, or along with their investor group, hold more than INR 25,000 crore (~ USD 3 billion) of equity AUM in the Indian markets.

FPIs falling within either of the above categories have been mandated to provide the granular details of **all** entities holding any ownership, economic interest, or exercising control in the FPI, on a full look through basis, up to the level of all natural persons, to their respective DDPs. The above details are required to be provided to DDPs without applying any thresholds.

To further remove the scope of any regulatory arbitrage, SEBI has defined the terms 'economic interest' and 'ownership interest' as 'returns from the investments made by the FPI' and 'ownership of shares or capital of the entity or entitlement to derive profits from the activity of the entity' respectively.

The SOP

The SOP, in addition to providing the details of disclosures required from FPIs falling within the above criteria also provides for conditions under which FPI(s) are exempt from providing granular disclosures. The details of such exempted entities have been provided under para 3.3 of the SOP.

Further, the SOP also provides the timelines for realignment of investments / providing granular information to DDPs as well as the timelines for surrendering of FPI license in case of non- compliance with the Disclosure Circular's requirements.

NDA VIEWS

The past year has been peculiarly full of action for FPIs in India. The Hindenburg Research Report which was published in January last year opened a pandora's box of regulatory loopholes being used by certain participants to bypass the framework governing FPIs. Since then, SEBI has taken numerous steps to plug those loopholes and the issuance of the Disclosure Circular is an instance of SEBI's increased vigilance in the FPI space.

Though the reasons for the steps taken by SEBI to make the system more transparent in the long run are understandable, these frequent changes and lack of clear guidance in implementation of the newly introduced requirements have generally led to concern amongst FPIs entering India. Further, the lack of public visibility on the correspondences from SEBI to DDPs have caused ambiguities and discomfort amongst the market participants. For instance, since the SOP has not been made publicly available on SEBI's website and is only available on the websites of certain DDPs / global custodians, FPIs are solely relying on their DDPs to timely forward SEBI's correspondences to them.

Additionally, the chain of communication from SEBI to DDP and DDP to FPIs is not ideal, and greater transparency and public access, by way of circulars, notifications or amendments is preferred.

– Ritul Sarraf, Prakhar Dua and Kishore Joshi

You can direct your queries or comments to the authors.

¹Available at <https://egazette.gov.in/WriteReadData/2023/244410.pdf>

²Available at https://sebi.gov.in/legal/circulars/mar-2023/streamlining-the-onboarding-process-of-fpis_69390.html

³Available at https://www.sebi.gov.in/legal/circulars/may-2023/direct-market-access-dma-to-sebi-registered-foreign-portfolio-investors-fpis-for-participating-in-exchange-traded-commodity-derivatives-etcds-_71069.html

⁴Available at https://www.sebi.gov.in/legal/circulars/jul-2023/mandating-legal-entity-identifier-lei-for-all-non-individual-foreign-portfolio-investors-fpis-_74420.html

⁵Available at https://www.sebi.gov.in/legal/circulars/aug-2023/transactions-in-corporate-bonds-through-request-for-quote-rfq-platform-by-fpis_75009.html

⁶Available at https://www.sebi.gov.in/legal/circulars/aug-2023/mandating-additional-disclosures-by-foreign-portfolio-investors-fpis-that-fulfil-certain-objective-criteria_75886.html

⁷Rules 19(2)(b) and 19A of Securities Contracts (Regulation) Rules, 1957, read with Regulation 38 of SEBI (Listing Obligations and Disclosure Requirements) Regulations, 2015 mandate the maintenance of a minimum public shareholding of at least 25% (subject to certain conditions) for every listed company.

⁸Available at https://dpiit.gov.in/sites/default/files/pn3_2020.pdf

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