Strengthening disclosure-based regime for FPIs – Challenges and Impact

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Abstract:
Foreign portfolio investment [FPI] has been a major area of policy focus in India since the securities markets had been progressively opened up from the early 1990s. Apart from the magnitude and volatility of FPI flows, round tripping and lack of transparency about the ultimate source/ beneficial owners [BOs] have been major policy-regulatory concerns. The Hindenburg Research Report has accentuated suspicion that some of the FPI clients are in collusion with certain promoter/promoter groups and could be violating the Minimum Public Holding Rules [MPS] and may even involved in price manipulation of such securities. Though such concerns are still to be substantiated by authorities, SEBI has decided to take additional steps to strengthen the regulatory oversight over the FPIs, particularly those with high concentration. Given the dynamics of global financial flows and the continued opacity and light-touch regulatory framework still available to FPIs in several jurisdictions, the success of such additionality approach could be limited. Rather, India should adopt a bold, level-playing disclosure-based regulatory approach to all regulated entities: both domestic and foreign.

Regulating foreign investment, either through the Foreign Direct Investment (FDI) route or through the Foreign Portfolio Investment (FPI) route is a difficult task. For many reasons. These investments come from various jurisdictions operating under different laws and regulations. Their business models, even by the same name or nomenclature, can be quite distinct across jurisdictions. National laws, like Indian securities laws, are *ipso facto* not applicable to them. The interplay of these factors and the inherent dynamic nature of the financial sector with its reliance on leap-frogging frontier technology, make the shapes of such entities, their activities and their approach to regulations in different jurisdictions keep changing fast. Particularly challenging is regulation of FPIs since they are footloose, nimble and can transfer huge amounts of funds in nano seconds across jurisdictions.

Despite all these challenges, many nations, including India, seek substantial amounts of external financial flows for various reasons. Hence, since 1995 SEBI has had a structured regulatory framework for portfolio flows in the form of Foreign Institutional Investor (FII) Regulations. After several amendments etc. the FII Regulations were replaced with SEBI [Foreign Portfolio Investors] Regulations in 2014, to be complied by foreign investors who propose to make portfolio investments in Indian securities.

On 23 September, 2019, SEBI notified a comprehensive FPI Regulations , replacing the FPI Regulations[i], 2014. It deals with the full gamut of issues of FPIs: eligibility, registration, code of conduct, record keeping and submission of information, trading, clearing, settlement procedure, investment restrictions, custodial procedure, conditions on issue of overseas derivatives instruments [ODIs] and so on. Further, based on the extent of regulation in their home jurisdictions, compliance with the Financial Action Task Force [FATF] norms and /or the level of governance of such entities FPIs are divided into category I and Category II funds under Regulation 5 of the FPI Regulations, 2019.

Categories of foreign portfolio investors.

(a)"Category I foreign portfolio investors include–

(i) Government and Government related investors such as central banks, sovereign wealth funds, international or multilateral organizations or agencies including entities controlled or at least 75% directly or indirectly owned by such Government and Government related investor(s);

(ii) Pension funds and university funds;

(iii) Appropriately regulated entities such as insurance or reinsurance entities, banks, asset management companies, investment managers, investment advisors, portfolio managers, broker dealers and swap dealers;

(iv) Entities from the Financial Action Task Force member countries, [or from any country specified by the Central Government by an order or by way of an agreement or treaty with other sovereign Governments], which are–

I. appropriately regulated funds;

II. unregulated funds whose investment manager is appropriately regulated and registered as a Category I foreign portfolio investor:
Provided that the investment manager undertakes the responsibility of all the acts of commission or omission of such unregulated fund;

III. university related endowments of such universities that have been in existence for more than five years;

(v) An entity (A) whose investment manager is from the Financial Action Task Force member country and such an investment manager is registered as a Category I foreign portfolio investor; or (B) which is at least seventy-five per cent owned, directly or indirectly by another entity, eligible under sub-clause (ii), (iii)and (iv)of clause (a) of this regulation and such an eligible entity is from a Financial Action Task Force member country:
Provided that such an investment manager or eligible entity undertakes the responsibility of all the acts of commission or omission of the applicants seeking registration under this sub-clause.

(b) *Category II foreign portfolio investors include all the investors not eligible under Category I foreign portfolio investors such as–*
   - *(i) appropriately regulated funds not eligible as Category-I foreign portfolio investor;*
   - *(ii) endowments and foundations;(iii) charitable organisations;(iv) corporate bodies;*
   - *(v) family offices;(vi) Individuals;(vii) appropriately regulated entities investing on behalf of their client, as per conditions specified by the Board from time to time;*
   - *(viii) Unregulated funds in the form of limited partnership and trusts;*

   Explanation*: *An applicant incorporated or established in an International Financial Services Centre shall be deemed to be appropriately regulated.

A full reading of the two categories would indicate that virtually all types of FPIs from most of the jurisdictions are eligible to be registered with SEBI. While most of the entities in category I are well-governed/ well-regulated, the same cannot be said about those in Category II. As given in the definitions part of the FPI Regulations, "appropriately regulated" means only that of regulated by the home regulator concerned; it does not indicate the degree/rigor of regulation. The given *Explanation* that 'an applicant incorporated or established in an International Financial Services Centre [IFC] shall be deemed to be appropriately regulated' further amplifies this point; many of the IFCs have very light touch regulation.

Further, sub-regulations (i) and (j) under **Regulation 22,** as reproduced, underscore the broad nature of the FPI Regulations, when it comes to identifying and information sharing on the BOs:

(i) undertake necessary ***KYC on its shareholders/ investors in accordance with the rules applicable to it in the jurisdiction where it is organised; [emphasis added]*** *(j) provide any additional information or documents including* ***beneficiary ownership details of their clients as may be required*** *by the designated depository participant or the Board or any other enforcement agency to ensure compliance with the Prevention of Money Laundering Act, 2002 and the rules and regulations specified thereunder, the Financial Action Task Force standards and circulars issued from time to time by the Board".*

Therefore, the 2019 FPI regulatory framework remains rather incomplete and weak. Particularly significant is the lack of sufficient emphasis on KYC and disclosure requirements relating to the ultimate, BOs investing through the FPIs, as applicable to Indian market intermediaries and participants. Further, many of the functions relating to maintenance of information, verification etc. have been delegated to the designated Depository Participants. Such a *friendly regulatory approach* is the result of multiple factors which include the policy requirement of substantial capital inflows for India, the differential degree and type of regulation over FPIs in their home jurisdictions and the adoption of that different regulatory framework as enabling factors by India, emanating from the concern that the global fund flows could bypass India.

Since FPI flows constitute a substantive chunk of the Indian capital market (in many years superseding the domestic institutional investors) any major volatility in the FPI flows becomes a matter of major policy concern. At the margin, given their size, the FPI flows can influence the performance of the stock market and its volatility, quite substantially. Hence the reluctant acceptance of the FPI flows even without disclosing their ultimate beneficiaries. While the two-type categorisation of FPIs is an attempt to reduce this information asymmetry, much success could not be achieved by India in removing the veil of secrecy and fully knowing the ultimate beneficiaries.

Subsequent to the Hindenburg Research Report and the debate on knowing the regulated entities better if not fully, SEBI came out with a Consultation Paper [CP] in May 2023[ii] proposing to seek additional disclosures by FPIs. Following the proposals in the CP, the SEBI Board approved the following changes, as per para 6 of a Press Release by SEBI on 28 June 2023[iii].

"6. Introduction of provisions for additional disclosures from Foreign Portfolio Investors

6.1 *With an objective to guard against (i) possible circumvention of regulations such as the requirement for Minimum Public Shareholding ("MPS") or disclosures under Substantial Acquisition of Shares and Takeovers Regulations, 2011 ("SAST") and/ or (ii) possible misuse of the FPI route to circumvent the requirements of Press Note 3 ("PN3"), the Board approved the amendment to SEBI (Foreign Portfolio Investors) Regulations, 2019, for implementation of the following proposal:*

6.1.1 *To mandate additional granular level disclosures regarding ownership, economic interest, and control, of objectively identified FPIs meeting the below mentioned criteria, on a full look through basis, subject to the conditions and exemptions as specified by the Board from time to time:*
FPIs holding more than 50% of their Indian equity AUM in a single Indian corporate group; (or) FPIs that individually, or along with their investor group as defined under Regulation 22(3) of the SEBI (Foreign Portfolio Investors) Regulations, 2019, hold more than INR 25,000 crore of equity AUM in the Indian markets.

6.1.2 *Certain entities are exempted from making such additional disclosures, which, inter-alia, include Government and Government related investors, Pension Funds and Public Retail Funds, certain listed ETFs, corporate entities and verified pooled investment vehicles meeting certain conditions.*

6.2 *Applicants with investors contributing 25% or more in the corpus that are mentioned in the Sanctions List notified by UN Security Council are ineligible for registration as FPIs. In March 2023, PML Rules threshold requirements for identification of BO were amended and currently stand at 10% for companies and trusts and 15% for partnerships and unincorporated."*

Limited likely impact

Though the exact wording of the new provisions will be available only on notifying the regulatory amendments, the press release on this issue highlights two areas of concern;

that is to guard against possible circumvention of minimum public holding norms and possible misuse of Press note 3. However, these 'additional granular disclosure requirements around ownership of economic interest or in control of objectively identified high-risk FPIs' have been restricted to either too concentrated single entity/group exposure and/or significant overall holding [more than Rs.25000 crore] in their India equity investment portfolio. This is estimated to be a small share of the existing FPI flows and as such the impact of these additional disclosure will be insignificant. As such the potential flow may not be impacted at all.

The call for additional information from FPIs [though a small sub-set] is an explicit realisation that India's regulations relating to foreign entities/ the BOs behind them are not sufficiently strong. While the FPI regulations try to address this deficiency in some ways, the explicit recognition of 'appropriately regulated jurisdictions', 'appropriately regulated entities' etc. provide sufficient operational flexibility to several such entities who are even located in FATF grey list. In fact, several such jurisdictions are not full members of FATF, yet. For instance, FPI flows from the Cayman Islands, which was in FATF grey list, to India jumped to Rs. 33,242.24 crore in 62 NSE listed companies by the end of FY21 from Rs. 8,732.53 crore in 28 listed Indian companies at the end of FY18, as reported by *Livemint*[iv].

In short, it may not be quite off the mark to state that the reach of SEBI in fully knowing the FPIs/BOs is rather limited. Therefore, in cases where such FPIs take substantive stake in Indian listed companies or in Indian market intermediaries can be serious concerns.

Compliance with FATF norms alone may not be sufficient when it comes to huge investments in the financial/ securities markets. The focus of FATF is mainly on money laundering and terrorist financing; not on investment in the securities markets *per se* following applicable laws. Hence, offshore heavens, which are major fund pooling centres, do not face any problems with normal fund/investment activities. Further, their domestic regulations are very light.

Many of the FPIs and the BOs behind them may actually come out of the application of the revised provisions within the three months' transition time proposed to be provided or shortly thereafter by *mutation* since these global operators are adept in shape shifting. The BOs have been reportedly camouflaging their concentrated positions in listed entities/ groups by slicing and routing their orders through more than one FPI.

Disclosure-based regulatory regime needs a complete revamp

As reported, the regulator is facing considerable difficulty to ascertain, with reasonable certainty, within a reasonable time, the entities involved, their interconnections, and sources of the volatility of share prices etc. as alleged in the Hindenburg Report. In the absence of complete information about the BOs, the regulator has to start from scratch to collect information and to come to a reasonable conclusion, which often takes years; each time an episode of similar nature happens. With all the consequences to the issuers, investors, and, at times, to the market and even the economy. The regulator of a sovereign State should not be struggling or apologetic in gathering information about any entity operating in Indian jurisdiction.

The disclosure-based regime[v], as practised now, does not distinguish between regulated entities who comply with regulations in letter and spirit and those who comply in letter only. In the process, the disclosure-based regime has promoted a culture of tick-boxing compliance. Full and fair disclosure relating to promoters/persons in control, promoter group, related parties and beneficial owners etc. is crucial in regulating the market fairly and efficiently. Given the growing complexity of corporates, intermediaries and investors, transactions through layered structures and involving multiple jurisdictions as in the case of the FPIs, any deficit in information will make regulation difficult and inefficient. The regulator will not be able to correctly identify group entities, the shareholding pattern, related party transactions, and related parties involved in violations.

Given such regulatory information asymmetry, it is high time that India adopts a more strengthened and improved disclosure-based regime so as to enable proper regulation of all its market intermediaries and participants, irrespective of domestic or external origin. A disclosure-based regime must know its constituents fully and the Indian legal system should have the final say in the operation of such entities in India. India needs a degree of transparency from all the regulated entities that the policy makers, regulators and other market participants are comfortable with. The alternative is to become a tax heaven and become a host for those trillions of dollars, whirlpools of global capital floating around. The middle path of muddling through, trying to attract foreign portfolio flows through a light-touch regulatory approach, would exacerbate uncertainty and volatility of flows, and policy-regulatory bargaining by the big offshore funds. While the old India might have been constrained to follow a light-touch approach because of capital/forex shortages, new India certainly does not have to be beholden to the opaque practices of foreign funds. The well-governed foreign funds ['good money'] will neither shy away from transparency enhancing regulations nor fly away from well-governed jurisdictions.

In the latest Budget Speech [2023-24][vi] of the Union Finance Minister, para 100 reads as follows: "To simplify, ease and reduce cost of compliance, financial sector regulators will be requested to carry out a comprehensive review of existing regulations. For this, they will consider suggestions from public and regulated entities. Time limits to decide the applications under various regulations will also be laid down.". This is an opportune time to revisit, among others, the FPI Regulations also in an effective manner so that the Indian market regulator knows all the entities it regulates fully and comprehensively.

Views are personal

[i] Securities and Exchange Board of India (Foreign Portfolio Investors) Regulations, 2019.
[ii] SEBI Consultation Paper on framework for mandating additional disclosures from Foreign Portfolio Investors (FPIs), May 2023.
[iii] SEBI Press Release 28 June, 2023 – Additional disclosure requirement for FPIs
[iv] Cayman FPIs raise stakes in Indian companies, *Livemint*, 12 July, 2021
[v] CKG Nair and M S Sahoo: Disclosures and disconnects, Financial Express, 02 June, 2023. https://www.financialexpress.com/opinion/disclosures-and-disconnects/3110776/
[vi] Government of India- Budget Speech, 2023-24