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CLUBBING OF FPI INVESTMENT LIMITS: THE 2018 REVIEW

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2018 has been a tumultuous year for Foreign Portfolio Investors (FPIs) with each quarter bringing about significant changes in their investment regime. Arguably, the clubbing of their investment limits has wreaked the most havoc of all such changes.

The clubbing of FPI investment limits is not something new. However, it was limited to situations wherein the same set of ultimate beneficial owners "invested through" multiple entities in the same Indian target. This meant that the 10% exposure limit for an FPI in a single Indian company was clubbed in situations of common ownership of FPIs. Essentially, this limit was introduced to deter the same set of investors who setup multiple vehicles to breach the 10% limit on investment by a single entity**.** The Securities and Exchange Board of India (SEBI) had also clarified *vide* the formal FAQs that in case the same investor or the same set of end investors were constituents of 2 or more FPIs and such investor(s) had a beneficial ownership of more than 50% in those FPIs, such FPIs would be regarded as an investor group and their investments would be clubbed.

However, in its circular dated 10 April 2018 on clubbing of FPI limits (April 2018 Circular) SEBI made radical changes to clubbing norms for FPIs. The April 2018 Circular introduced 2 key concepts:

- The beneficial owner would be identified in accordance with Rule 9 of the Prevention of Money Laundering (Maintenance of Records) Rules 2005 (PMLA Rules) (i.e., 25% in case of companies and 15% in case of partnership firms, trusts and unincorporated association of persons); and

- Investments by FPIs would be clubbed if such FPIs had common 'beneficial owners', which also included entities which were under 'common control.

Due to the far-reaching ramifications of this Circular, various representations were made by the industry to SEBI. This led the Finance Ministry and SEBI to set up a committee chaired by Mr HR Khan to look into the issues raised by the stated circular. Please refer to our earlier articles dated 17 April 2018 and 14 September 2018.

Subsequently, based on recommendations made by the HR Khan Committee, SEBI, by way of a circular dated 21 September 2018 (September Circular), clarified that the guidelines for determination of beneficial ownership under the PMLA Rules were to apply only for the limited purpose of "KYC" and not for clubbing of FPI investments. SEBI was to separately notify any amendments to the SEBI (Foreign Portfolio Investors) Regulations 2014 (FPI Regulations) in this regard.

On 13 December 2018, SEBI clarified that the 'common control' test would continue to apply to club investments made by FPIs. Additionally, SEBI finally defined "control", aligning it with the definition in the SEBI (Substantial Acquisition of Shares and Takeovers) Regulations 2011 (Takeover Code), as the right to control management and policy decisions and excluded the "common control" requirement in case of public retail funds. Hence, the "common control" test for clubbing extends to all FPIs except for mutual funds and unit trusts open to retail investors, insurance companies and pension funds. While this exemption for retail funds helps offshore mutual funds, there remain many focused alternative investment funds adversely affected by this clubbing.

Recently, on 31 December 2018, SEBI made it clear that the "common control" test was here to stay, by amending the FPI Regulations. The FPI Regulations now specifically state that multiple entities having (i) common ownership, directly or indirectly, of more than 50%; or (ii) common control, shall be treated as being part of the same investor group and the investment limits of all such entities would be clubbed.

Comment

Many offshore funds invest in India as FPIs, several of which are managed under the same marquee asset manager. While these funds might be under the larger umbrella of a common asset manager, one must be conscious of how they are managed by distinct entities with different teams with independent outlooks and distinct strategies. Given that the manager of an FPI will be deemed to have control over its fund (and hence, under common control of the ultimate holding entity), this "common control" threshold would club the FPI investment limits of all such funds managed by the same asset manager and funds under the same corporate group. Such corporate groups may have to allocate their Indian targets amongst the funds managed under them, being careful to not breach the 10% stake collectively permissible for the entire corporate group. This may be a cumbersome exercise, especially in light of segregated functioning of the individual fund managers and different entities within the corporate group.

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