



## **Regulatory Alert** Stay Ahead...

### **SEBI tightens KYC norms for FPIs**

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## Background

In India, the Know Your Client (KYC) requirements are primarily governed by the Prevention of Money Laundering Act, 2005 (PMLA) and the Prevention of Money Laundering Rules, 2005 (PMLA Rules).

In respect of Foreign Portfolio Investors (FPIs), the Securities and Exchange Board of India (SEBI) has prescribed simplified KYC norms depending upon the category of FPIs. For instance, Category I and II FPIs are subject to fewer KYC requirements, as compared to Category III FPIs. Also, there have been many clarifications issued by SEBI concerning KYC requirements in response to questions raised by FPIs as well as market participants.

In a circular issued on 10 April 2018 (the circular), SEBI has tightened the KYC norms applicable to FPIs especially with regard to investment by resident Indians and non-resident Indians (NRIs) in FPIs.

## Key changes

The key changes announced in the circular are:

### Identification and verification of beneficial owners

- **NRIs and resident Indians not permitted to be beneficial owners of a FPI:** It is categorically stated in the circular that NRIs or Overseas Citizens of India (OCI) or resident Indians cannot be a beneficial owner (BO) of an FPI. In this context, the term "beneficial owner" needs to be interpreted in accordance with the circular as well as criteria provided in Rule 9 of PMLA Rules whereby a **BO would be a natural person or persons, who, whether acting alone or acting together, have controlling ownership interest in the FPI or control over the FPI and if a BO cannot be identified in this manner, the senior managing official of the FPI would be construed to be its BO.** Please refer to Annexure 1 for definition of BO.

Though the circular prohibits NRIs / OCIs to be BO of the FPI, it reiterates that **an entity promoted by NRIs / OCIs can be an investment manager of FPI** provided it is a non-investing entity.

- **Look through principle to be applied for identifying BO:** Where an entity (i.e. non-individual) is a material shareholder /owner of the FPI as per the thresholds mentioned in Annexure 1, the BO of such entity also needs to be identified.
- **Real owners/ effective controllers to be identified:** Where the FPI is a company or Trust and is represented in India by its service providers, it should provide information of the persons that effectively own or control the FPI. Also, if control is exercised through means such as voting rights, agreements, arrangements etc., it should be specified.
- **Nominee not a beneficial owner:** A nominee is not to be considered as a BO of the FPI.

- **Other persons not permitted to be BO:** Following persons cannot be BO of FPI:
  - Person mentioned in United Nations Security Council's Sanctions List
  - Person from jurisdictions identified in the public statement of Financial Action Task Force as:
    - a jurisdiction having a strategic Anti-Money Laundering or Combating the Financing of Terrorism deficiencies to which counter measures apply; or
    - a jurisdiction that has not made sufficient progress in addressing the deficiencies or has not committed to an action plan developed with the FATF to address the deficiencies.
  
- **FPIs not compliant with new BO restrictions prohibited to enter into fresh positions post April expiry:** In case an existing FPI is not in compliance with BO restrictions specified in the circular, it will not be allowed to create fresh position at the end of expiry of derivative contracts of April 2018. Further, such an FPI needs to either make necessary changes to its BO structure to comply with the circular within 6 months or close all their existing positions in the Indian securities market.
  
- **Specific format prescribed for reporting of BO information by FPIs:** Category II and III FPIs need to provide the list of BOs and the list should contain the following information:
  - Name & Address of the BO (Natural Person)
  - Date of Birth
  - Tax Residency Jurisdiction
  - Nationality
  - Whether acting alone or together through one or more persons as group, with their name & address
  - BO Group's percentage Shareholding / Capital / Profit ownership in the FPIs
  - Tax Residency Number/ Social Security Number/ Passport Number of BO

The above information is required to be submitted within 6 months from the date of the circular.

#### **Other announcements**

- **Bearer share structure not permitted:** FPI as well as BOs of FPIs will not be permitted to issue bearer shares. In case of non-compliance, the FPI or its BO (as the case may be) needs to take necessary actions to ensure compliance with this requirement
  
- **Periodical KYC review:** At present, FPIs are subject to KYC review as and when there is a change in material information/ disclosure intimated by the FPIs. Henceforth, the concerned Designated Depository Participant (DDP) or the custodian needs to carry out comprehensive KYC review of FPI on periodical basis (1 year / 3 years) depending upon the risk categorisation of the FPI.
  
- **Undertaking / declaration to be provided by FPIs on exempted KYC documents:** FPIs are exempted from providing certain KYC documents. It is now mandated that FPIs need to submit an undertaking/ declaration to the DDP/ custodian that they shall provide such documents upon demand by Regulators or Law enforcement Agencies. The declaration/ undertaking is required to be submitted within 6 months from the date of the circular.

- Clubbing of investments for the purpose monitoring investment limits: Investments made by multiple FPIs forming part of an investor group with common BOs are clubbed to ensure that the total holding of the investor group in equity shares of an Indian company is less than 10% of the paid up capital of the Indian company. At present, the clubbing of investments is on the basis of the investor group information provided by the FPI in clause 2.2 of the FPI Application Form (Form A). Henceforth, the clubbing of investments would be on the basis of common BOs identified in accordance with the circular. Also, in case the new basis of clubbing of investments results in a breach of the 10% investment limit, the concerned FPI would need to take necessary actions within 6 months from the date of the circular to ensure compliance.

Further, in case there is a breach of the 10% investment limit at an investor group level (i.e. after clubbing investments of all the common BOs) in future, the concerned FPI may either treat the entire investment in the concerned Indian company as Foreign Direct Investment (FDI) or divest the excess shareholding within 5 trading days from the date of settlement of trades which resulted in the breach of the investment limits.

Source: SEBI Circular number CIR/IMD/FPIC/CIR/P/2018/64 dated 10 April 2018

## Our comments

The SEBI circular has restricted the KYC norms applicable to FPIs and at the same time extended the KYC compliance requirements to be followed by FPIs as well as DDPs/ custodians. The key takeaways for FPIs from the circular are summarized below:

- FPIs would need to implement appropriate procedures to ensure that NRIs, resident Indians and other persons prohibited in the circular are not the BOs. Also, it is pertinent to note that in case of companies and trusts, BO includes not only the persons with controlling ownership interest (which includes ownership or entitlement to shares or capital or profits), but also the persons who exercise control over the FPI. In case of non-compliant structures, the concerned FPI would need to take necessary corrective action before 10 October 2018.
- In case of FPIs which deal in Indian derivatives, the identification of BOs needs to be completed before 26 April 2018 since the circular prohibits non-compliant FPIs to create fresh positions in derivatives at the end of the expiry of derivative contracts of April 2018.

Though the circular provides detailed guidance on KYC requirements for FPIs, there may be a need for clarity on certain aspects as discussed below:

- Control - Control is defined very broadly in PMLA rules to include the right to appoint majority of the directors or to control the management or policy decisions including by virtue of their shareholding or **management rights** or **shareholders agreements** or **voting agreements**. Considering the broad definition, would persons, who have majority ownership or control over the sponsor or Investment manager which controls the FPI (through management shares or otherwise) be considered to be the BO of the FPI?
- Senior Managing official – The term “senior managing official” is not defined either in the PMLA rules or SEBI circular. A few relevant questions in this context could be:

- If the CEO / COO / CIO or any other senior official of a broad-based fund is an NRI, would such entity be ineligible to invest in India as an FPI?
- Would the restriction on senior managing official get extended to investment manager of FPI as well?
- Acting together - Would investment by members of a family be clubbed for the purpose of materiality threshold? How would it be ascertained if certain individuals are acting together?
- Look through – Is look through approach required to identify BO for an entity which does not make investments in the FPI but such entity exercises control over the FPI through other means?
- List of BOs to be provided by FPIs – As of which date the information needs to be provided by FPIs? Also, at what frequency would this information need to be provided in the future?
- Clubbing of investments – Is there a need to club investments if there are more than 50% common BOs for two or more FPIs on the basis of control or on the basis of senior managing official but not on the basis of controlling ownership interest?
- Listed companies – Though PMLA Rules exempt listed companies from identifying BOs, the SEBI circular does not provide such exemption. Does that mean that even a publicly listed fund (in an overseas stock exchange) needs to put in checks to ensure NRIs / OCIs / resident Indians do not own more than 15% / 25% shares of the fund?

**Annexure 1 – In accordance with SEBI circular dated 10 April 2018 read with rule 9(3) of PMLA Rules 2005, the BO has to be determined as follows:**

- a) **FPI is a company:** - The beneficial owner is the natural person(s), who, whether acting alone or together, or through one or more juridical person, has a controlling ownership interest or who exercises control through other means. For the purpose of this definition;
  - Controlling ownership interest means ownership of or entitlement to more than 25% of shares or capital or profits of the company;
  - Control shall include the right to appoint majority of the directors or to control the management or policy decisions including by virtue of their shareholding or management rights or shareholders agreements or voting agreements;
- b) **FPI is a partnership firm:** The beneficial owner is the natural person(s) who, whether acting alone or together, or through one or more juridical person, has ownership of/entitlement to more than 15% of capital or profits of the partnership
- c) **FPI is a unincorporated association or body of individuals:** The beneficial owner is the natural person(s), who, whether acting alone or together, or through one or more juridical person, has ownership of or entitlement to more than 15% of the property or capital or profits of such association or body of individuals.
- d) **FPI is a Trust:** The identification of beneficial owner(s) shall include identification of the author of the Trust, the trustee, the beneficiaries with 15% 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
- e) **FPI based in high risk jurisdiction:** If the FPI is based in high risk jurisdiction (to be determined in accordance with SEBI Master Circular no. CIR/ISD/AML/2010 dated 31 December 2010), a lower materiality threshold of 10% is to be applied to identified BO instead of 25% / 15% mentioned above

- f) **No natural person owning material interest or control** – Where no natural person is identified under (a), (b), (c) or (d) read with (e) above, the beneficial owner is the relevant natural person who holds the position of senior managing official

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