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FPI - OVERVIEW OF REGULATORY OVERHAUL

Securities and Exchange Board of India ("**SEBI**") has recently, issued various notifications and circulars on investments by Foreign Portfolio Investors ("**FPIs**") inter alia on ease of entry norms for FPIs, know your client requirements to be followed for identification of beneficial owners of FPIs etc. Further, the Reserve Bank of India ("**RBI**") has issued various circulars on conditions and limits to be followed by FPIs for investments in debt securities. Set out below are the key takeaways from the circulars issued by SEBI and RBI.

Easing of Access norms for investments by FPIs:

- SEBI Circular dated February 15, 2018[1] has eased out the processes that FPIs / Designated Depository Participants ("**DDPs**") had to follow with respect to investments by FPIs. Set out below are some of the key relaxations:

  (a) No prior SEBI approval required for change in the local custodian or DDPs subject to compliance with prescribed conditions;
  (b) No prior SEBI approval required for free of cost transfer of assets between FPIs operating under multiple investment managers structures and having same Permanent Account Number;
  (c) Simplification of procedure for issuance of new class of shares by FPIs having common portfolio and segregated portfolio;
  (d) Appropriately regulated private banks / merchant bank to be allowed to invest on behalf of their clients' subject to compliance with prescribed conditions; and
  (e) In case there is no change in the investor grouping requirements or Protected Cell Company /Multi-Class Vehicle declarations and undertaking at the time of continuance of registration of an FPI, the DDP may rely on the specific declaration from the FPI that there is no change in the information earlier provided to the DDP; and thus, no fresh declaration is to be submitted by the FPI.

- Subsequently, SEBI issued a clarificatory circular dated March 13, 2018[2] introducing additional safeguards and restrictions for investment by Category II FPIs (mutual funds, banks, university funds, etc.). The said circular clarifies the following:

  (a) Collective investment vehicle of private banks / merchant banks investing on behalf of their clients are required to adhere to a list of conditions. One such condition being that the client / investor or their beneficial owner should not be a non-resident Indian;
  (b) Appropriately regulated broad based insurance / reinsurance companies must maintain common portfolio of theirinvestments in India. Segregated portfolio or investor / policy holder level investment structure shall not be permitted; and
  (c) Other appropriately regulated persons registered as Category II FPI viz. asset management companies, investment managers/ advisers, portfolio managers, broker dealer and swap dealers are permitted to invest their proprietary funds. In case such entities take a separate registration, they can invest their clients' funds as an Offshore Derivative Instrument issuing FPI or fulfil the condition of being broad-based and having common portfolio. However, asset management companies having thematic portfolios can also have segregated structure if each theme is broad-based.

Know Your Client requirements for FPIs: SEBI has issued a circular dated April 10, 2018[3] inter alia on Know Your Client ("**KYC**") requirements of FPIs investing under portfolio investment scheme. The key requirements under the above-mentioned circular is given below:

[1] *CIR/IMD/FPIC/26/2018*
[2] *CIR/IMD/FPIC/47/2018*
[3] *CIR/IMD/FPIC/CIR/P/2018/64*

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Identification and verification of Beneficial Owners

- The circular provides for manner of identification and verification of Beneficial Owner ("**BO**") of FPIs. BO is defined to mean the natural person who ultimately owns or controls an FPI and should be identified in accordance with Rule 9 of Prevention of Money laundering (Maintenance of Records) Rules, 2005.

- Accordingly, the materiality threshold for identification of BOs of FPIs on controlling ownership interest (or ownership / entitlement) basis shall be 25% in case of company and 15% in case of partnership firm, trust & unincorporated association of persons. However, in respect of FPIs coming from 'high risk jurisdictions',DDPs may apply lower materiality threshold of 10% for identification of BO and seek KYC documentation as is applicable for a Category III FPIs.

- Further, where no BO is identified using the materiality threshold for controlling ownership interest basis and on control basis (for companies and trusts), BO shall be senior managing official of the FPI.

- Additionally, certain conditions and clarifications on applicability of the materiality thresholds for identification of BO of FPIs have been laid out in the circular.

Non-Resident Indian as BO of FPI

- Further, the circular provides clarification that Non-Resident Indian / Overseas Citizen of India cannot be BO of FPIs. However, if an FPI is Category II Investment Manager of other FPIs and is non-investing entity, it may be promoted by Non-Resident Indians / Overseas Citizens of India.

- The existing FPI structures not in conformity with the circular requirements are not permitted to create fresh position at the end of expiry of derivative contract of April 2018. Such FPIs are given time of 6 months to change their structure to conform with the circular or close their existing position in Indian securities market.

- Further, the circular has issued clarifications on bearer share structure andKYC documentation for category III FPIs.

Investment by FPIs in debt

- RBI issued circulars dated April 27, 2018[4] and May 1, 2018[5] (collectively, the "**RBI Circulars**") prescribing, *inter alia*, certain investment concentration limits and conditions for investments by FPIs in debt securities.

- The RBI Circulars prescribe, *inter alia*, the following:

  (a) For Corporate bonds:

  (i) Single / group investor-wise limit in corporate bonds:

  - Investment by FPI, including related FPIs[6], should not exceed 50% of any single issue of a corporate bond;
  - No FPI is allowed to invest more than 20% of its corporate debt portfolio to a single corporate (including investment to entities related[7] to the corporate); however, a newly registered FPI[8] is required to comply with this investment restriction starting no later than 6 months from the commencement of its investments; and

  (ii) Investments by an FPI in corporate bonds with residual maturity below one year is

[4] *RBI/2017-18/168 A.P. (DIR Series) Circular No. 24.*
[5] *RBI/2017-18/170 A.P. (DIR Series) Circular No. 26.*
[6] *All FPIs registered by a non-resident entity. Illustratively, if a non-resident entity has set up five funds, each registered as an FPI for investment in debt, total investment by the five FPIs will be considered for application of concentration and other limits.*
[7] *The term 'related entities' shall have same meaning as defined under section 2(76) of Companies Act, 2013*
[8] *An FPI registered with SEBI after April 27, 2018.*

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permitted and the same shall not exceed, at any point in time, 20% of the total investment of that FPI in corporate bonds.

(b) For Government Securities (**G-Secs**) and State Development Loans ("**SDLs**"):

(i) Investment by an FPI in G-Secs and SDLs with residual maturity of below one year is permitted and the same shall not exceed, at any point in time, 20% of the total investment of that FPI in that category.

(ii) The cap on aggregate FPI in any G-Sec has been revised from 20% to 30% of the outstanding stock of that security.

(c) Other conditions:

(i) Investment by FPIs (including related FPIs) in each three categories of debt viz. G-secs, SDLs ad corporate debt securities, shall be subject to the following conditions:

- Long term FPIs: 15% of the prevailing investment limit for that category;
- Other FPIs: 10% of the prevailing investment limit for that category.

(ii) FPIs are not allowed to invest in partly paid instruments

(iii) FPIs can now invest in treasury bills issued by the Central Government.

The aforementioned circulars and notifications issued by SEBI and RBI propose to further ease the access norms for investments by FPIs in Indian securities market and promote growth in Indian debt market. Although, the regulatory intent to ease the access norms for investments by FPIs is a welcome move, there are certain issues that may require clarifications from the regulators.

MINIMUM CAPITALIZATION NORMS FOR FDI IN UNREGULATED FINANCIAL SERVICES – ARE WE BACK TO SQUARE ONE?

Recently, the Ministry of Finance issued a Press Release dated April 16, 2018 ("**Press Release**") wherein it announced minimum capitalisation norms for foreign investment in '*other financial services*' activities that are unregulated /exempted/ unregistered. Prior to the Press Release, 100% foreign investment under the automatic route was permitted in 'other financial services' activities that are regulated by one of the financial services regulators without any additional capitalisation norms (except those prescribed by the regulators). However, for '*other financial services*' activities that are not regulated by any financial sector regulators or where only part of the financial services activity is regulated or where there is doubt regarding the regulatory oversight, prior government approval was required for making foreign investment.

*Press Release:*As per the Press Release, any unregulated /exempted/ unregistered entity carrying out fund and/or non-fund based activities are required to adhere to the following minimum capitalisation norms:

Activities	Minimum FDI Capital
Fund based activities	USD 20 million
Non-fund based	USD 2 million

Further, the Press Release has clarified that activities that are classified as fund based and non-fund based activities. The fund based activities includes merchant banking, underwriting, portfolio manager, stock broking, asset management, venture capital, custodian services, credit card business, micro, credit, rural credit, leasing &finance housing finance, factoring. Non-fund based activities include investment advisory services,

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financial consultancy, forex broking, money changing business, credit rating agencies.

The Press Release has provided an explanatory note to clarify the meaning of activities not regulated by any financial sector regulator. It provides that activities not regulated by any financial sector regulator shall include entities which are not registered with the concerned sector regulator and/or the entity/activity is exempted under the concerned sector regulations or where there is a doubt regarding the regulatory oversight.

Our View:

The Press Release will have adverse impact asset managers managing alternative investment funds, core investment companies and such other entities that are either exempted or unregistered (but still have regulatory oversight) from seeking foreign investment. The Press Release is not clear on aspects such as, whether it operates retroactively or prospectively?; whether FDI capital will be over and above regulatory prescribed capital adequacy requirement?; whether minimum FDI capital will apply in respect each unregulated/exempt activity independently? etc. Therefore, it would be helpful if a formal announcement is made by RBI / Ministry of Finance clarifying the foregoing ambiguities arising from the Press Release.

PERSONAL GUARANTEE – CREDITOR'S RECOURSE TO CREDITOR'S REMORSE?

The advent of liberalization and privatization bolstered extensive borrowing and lending in India, thereby increasing accessibility to funds and promoting businesses in India. With increasing business, came increasing fund requirement, which eventually led to an upsurge in the exposures taken by banks and financial institutions. Bank and financial institutions often collateralised these exposures with personal guarantees issued by promoter of the borrower, since a contract of guarantee would enable recovery of debt from the promoter, in case of a default on the part of the borrower to repay such debt. However, it appears that the order of the National Company Law Appellate Tribunal (NCLAT) ("**NCLAT Order**") in the matter of *State Bank of India vs. V. Ramakrishnan and Veesons Energy Systems Private Limited* ("**Veesons Matter**"), has clipped creditor's ability to proceed against guarantor whilst the borrower is undergoing a corporate insolvency resolution process ("**CIRP**") in accordance with the Insolvency and Bankruptcy Code of India, 2016 ("**Code**").

The underlying principle of CIRP is maximization of value of assets of the debtor to the end that the creditors are able to recover debts and the debtor is resurrected rather than liquidated. At the heart of value maximization principle is the concept of moratorium enshrined in Section 14 of the Code, which effectively prohibits: (a) institution or continuation of legal proceedings against the debtor, (b) transferring, encumbering or alienating the assets of the debtor, and (c) continuation of foreclosure or recovery actions against debtor under Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002 ("**SARFAESI**"). The imposition of moratorium immediately upon commencement of CIRP essentially ensures that the debtor remains immune to legal and recovery proceedings during the CIRP. Interestingly, the NCLAT Order has extended this immunity to a promoter, who furnished a personal guarantee in favour of a creditor in relation to the debt availed by the corporate debtor.

Facts of Veesons Matter

In the Veesons Matter, the State Bank of India ("**SBI**") had initiated recovery proceedings against the promoter of Veesons Energy Systems Private Limited ("**Veesons**") being Mr. V. Ramakrishnan ("**VR**") who had furnished a personal guarantee to secure the debt availed by Veesons from SBI. In course of the recovery proceedings, SBI issued a sale notice under SARFAESI against the personal property of VR. After unsuccessfully challenging the sale notice before the Hon'ble High Court at Judicature in Chennai, Vessons initiated voluntary CIRP under Section 10 of the Code before the National Company Law Tribunal at Chennai ("**NCLT Chennai**") and admitting the CIRP application, NCLT Chennai declared moratorium under Section 14 of the Code.

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Whilst SBI pursued the recovery proceedings against VR after the declaration of moratorium, VR made an application to NCLT Chennai, *inter alia*, praying for the recovery proceedings to be stayed on the ground that, under Section 140 of the Indian Contract, Act 1872 ("**ICA**") invocation and enforcement of the guarantee by the creditor against a guarantor would subrogate such guarantor to the position of the creditor and vest such guarantor with all rights that the creditor had against the debtor. Effectively, VR prayed that enforcement of the personal guarantee by SBI would subrogate VR into the position of SBI which would tantamount to transfer of security interest in Veesons' assets from SBI to VR, thereby violating Section 14 (1) (b) of the IBC. Section 14(1)(b) of the Code, *inter alia* prohibits corporate debtor from transferring, encumbering, alienating or disposing of its assets during the moratorium period.

Veesons Order

Affirming the ground mentioned above, NCLT Chennai restrained SBI from pursuing any recovery proceedings against VR ("**NCLT Order**"). SBI challenged the NCLT Order in an appeal before NCLAT, however the NCLAT upheld the view of NCLT Chennai and dismissed the appeal.

Analysis

Much to a creditor's dismay, the obvious outcome of the NCLAT Order is that a creditor will not be able to enforce a personal guarantee, or for that matter, any security interest akin to a guarantee, during the moratorium period which may extend upto 270 (two hundred and seventy) days from the commencement of CIRP. Deferred enforcement of security interest vitiates the recovery right of a creditor and renders such security interest infructuous. At the same time, permitting creditors to invoke guarantee may also stir up an absurd legal situation for the guarantor where – on one hand invocation and enforcement of guarantee would transfer the security interests in the assets of the corporate debtor from the creditor to the guarantor by operation of Section 140 of the ICA and on the other hand the guarantor would not be able to exercise any debt recovery action against the corporate debtor till the expiry of the moratorium by virtue of Section 14 (a) and (c) of the Code. It is worthwhile to note that the National Company Law Tribunal at Kolkata in the matter of *ICICI Bank Limited vs. Vista Steel Private Limited*, has aligned itself with the view laid down in the NCLAT Order. However, the National Company Law Tribunal at New Delhi and NCLAT have permitted invocation of the guarantees during the pendency of CIRP in the matters of *Alpha & Omega Diagnostics Limited vs. Asset Reconstruction Company of India Limited* and *Shweitzer Systemtek India Private Limited vs. Phoenix ARC Private Limited*, respectively. Each of these orders were passed before the NCLAT Order was passed in the Veesons Matter.

Conclusion

The apparent inability of the Code, in its present form, to reconcile the legal tussle between the principles of law of guarantee enshrined in Section 140 of the ICA and Section 14 of the Code has been discussed at length by the Insolvency Law Committee ("**Committee**") in its report dated March 26, 2018 ("**Report**"). The Committee has discussed the aforementioned orders (including the NCLAT Order) in paragraph 5.5 to 511 of the Report and has suggested that an explanation to Section 14 of the Code may be inserted to clarify that the contours of Section 14 extend to the assets of a corporate debtor and there is no bar on enforcement actions sought to be initiated against the assets of a guarantor.

Till the clarification is brought about by the Parliament, a recourse-less guarantee is bound to make a remorseful creditor!

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Ministry of Corporate Affairs amends norms relating to prospectus and allotment of securities

The Ministry of Corporate Affairs has vide its notification dated May 7, 2018 has amended the Companies (Prospectus and Allotment of Securities) Rules, 2014 by omitting Rule 4, Rule 5 and Rule 6, which, *inter alia*, lists down the disclosures and information to be provided in the prospectus, the matters and reports to be attached thereto and the period within which such information, disclosure, matters and reports are to be provided. Since these matters are already covered under the relevant regulations of Securities and Exchange Board of India, the amendment is aimed at doing with duplication.
[Source: http://www.mca.gov.in/Ministry/pdf/CompaniesProspectusRules_07052018.pdf]

Securities and Exchange Board of India issues disclosure norms for mutual funds / asset management companies for performance of post-merger schemes

The Securities and Exchange Board of India has *vide* its circular dated April 12, 2018 released disclosure norms to be followed by mutual funds depicting the disclosure of performance of their schemes post the merger of schemes. Further, the circular prescribes that past performance of schemes whose features are not retained post merger, may be made available on request. Prior to this circular there were no specific guidelines governing the depiction of performance of the schemes surviving after merger.
[Source: https://www.sebi.gov.in/legal/circulars/apr-2018/performance-disclosure-post-consolidation-merger-of-schemes_38674.html]

Insolvency and Bankruptcy Code Amendment (Ordinance) 2018

The Cabinet has approved new amendments to the Insolvency and Bankruptcy Code, which attempts to ease the rules by reducing the threshold for resolution approvals, and enabling promoters of MSMEs to bid. The amendment also seeks to treat homebuyers on par with financial creditors. The ordinance awaits the assent of the President.
[Source: https://economictimes.indiatimes.com/industry/banking/finance/banking/bigger-say-for-home-buyers-in-modi-governments-bankruptcy-code-tweak/articleshow/64288579.cms]

Master Circular for Debenture Trustees

The Securities and Exchange Board of India has compiled all regulations on Debenture trustees and issued a master circular on the subject. The master circular has consolidated and provides for guidelines on online registration mechanism for debenture trustees; disclosure requirements of trust deeds etc., provisions of redressal of investor grievances and guidelines for outsourcing of activities by debenture trustees.
[Source:https://www.sebi.gov.in/legal/master-circulars/apr-2018/master-circular-for-debenture-trustees-dts-_38608.html**]**

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