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DECODING THE DNA OF FOREIGN INVESTMENT: SEBI'S QUEST FOR TRUE BENEFICIARIES

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Introduction

The Foreign Portfolio Investor (FPI) regime in India is a crucial gateway for international capital entering the country's securities markets. Governed by stringent regulations, these guidelines are designed to attract foreign investments while maintaining market integrity. Central to this framework are the rigorous Know Your Customer (KYC) protocols required for FPI registration, emphasizing the identification and verification of Beneficial Owners (BOs) as mandated by Rule 9 of the Prevention of Money Laundering (Maintenance of Records) Rules, 2005 (PMLR)⁷³⁷. This process is essential to India's robust Anti-Money Laundering (AML) and Countering Financing of Terrorism (CFT) systems, ensuring the integrity of its financial markets.



⁷³⁷ SEBI's recent FPI BO and SMO requirements, ICI, <https://www.ici.org/system/files/2023-08/23-cl-joint-letter-sebi-re-fpi-bo-smo-rqmnt.pdf> (last visited on 16th June, 2024)

Understanding the FPI Framework

The FPI framework integrates various regulatory aspects aimed at maintaining transparency and preventing financial malpractices. SEBI's stringent KYC protocols play a pivotal role in this framework, ensuring that the true owners of foreign investments are identified and verified. The PMLR's approach to identifying BOs combines quantitative benchmarks with qualitative assessments to encompass a broad range of controlling interests. Quantitatively, individuals with significant economic stakes are classified as BOs: a 10% ownership threshold for companies, and 15% for trusts and partnerships. Qualitatively, the PMLR also considers those who have control over an entity's operations, such as through the appointment of directors or influence over management decisions.

The Dual Criterion for Identifying Beneficial Owners

When primary criteria fail to identify a natural person as the BO, regulations default to naming the Senior Managing Official (SMO) as the BO, ensuring a responsible individual is always identified, even in complex ownership structures.⁷³⁸ This dual criterion captures both explicit and subtle forms of control, providing a comprehensive approach to identifying beneficial ownership. This meticulous identification process is crucial for mitigating risks associated with money laundering and terrorism financing, thereby maintaining the financial system's transparency and stability.

SEBI's Consultation Paper and Regulatory Vigilance

SEBI's regulatory vigilance adapts to the evolving global financial landscape. A significant step in this evolution was the May 31, 2023 release of a Consultation Paper proposing enhanced disclosure requirements for FPIs with

specific risk profiles.⁷³⁹ This was in response to SEBI's observations concerning market behaviors. One major concern was the potential evasion of the Minimum Public Shareholding (MPS) norms, as SEBI noticed FPIs making large, concentrated investments in single companies without significant change over time. This raised suspicions of attempts to bypass MPS requirements, which are designed to ensure broad public ownership of listed entities. The consultation paper's recommendations reflect SEBI's proactive approach to identifying and mitigating emerging risks in the financial market.

Addressing Takeover Regulations and Ownership Thresholds

SEBI also worried about the misuse of the FPI route to circumvent takeover regulations, fearing that FPIs could be used to quietly acquire shares or control in listed companies without triggering mandatory open offer rules meant to protect minority shareholders. The existing BO identification framework posed challenges, as the PMLR thresholds often resulted in no natural person being flagged as a BO based on economic interests, leading to frequent designation of the SMO as the BO. This practice, though legally compliant, potentially obscured the real beneficiaries behind complex ownership structures. SEBI's concerns highlight the need for continuous monitoring and updating of regulations to address loopholes and prevent regulatory evasion.

Fragmented Ownership Arrangements and National Security

Additionally, SEBI observed fragmented ownership arrangements where one individual could exert significant control over an FPI through multiple investment entities, each holding small stakes that collectively amounted to substantial control but individually fell below the 10% BO threshold. This fragmentation can

⁷³⁸ SEBI's Quest for Transparency, Paras Varyani, <https://indiacorplaw.in/2023/10/sebis-quest-for-transparency-decoding-the-disclosure-mandate-and-the-impact-on-fpis.html> (last visited on 15th June, 2024)

⁷³⁹ Relaxation in timelines for disclosure of material changes by Foreign Investors, SEBI, https://www.sebi.gov.in/sebi_data/meetingfiles/apr-2024/1713324539085_1.pdf (last visited on 16th June, 2024)

obscure true ownership and control, complicating regulatory oversight. Further concerns arose from the FPI regime's interaction with national security considerations, particularly those in Press Note 3 (PN3) from April 17, 2020. PN3 imposed strict restrictions on investments from countries sharing land borders with India but did not cover FPI investments, creating a loophole that could be exploited.⁷⁴⁰ Addressing these fragmented ownership structures is essential for maintaining the integrity and security of the financial market.

Enhanced Disclosure Requirements and Market Integrity

In response, SEBI proposed enhanced disclosure requirements for high-risk FPIs to uncover the true natural persons behind complex investment structures and scrutinize FPI investment patterns more closely. These measures aim to strengthen market integrity, protect investors, and align India's FPI regime with global best practices in transparency and beneficial ownership disclosure. By requiring more detailed information on BOs, SEBI aims to prevent the misuse of FPIs for illicit activities and ensure that the actual controllers of investments are transparent and accountable.

The Necessity for Sophisticated Oversight Mechanisms

This regulatory development highlights the necessity for sophisticated oversight mechanisms in an era of global financial interconnectedness. SEBI's balanced approach—encouraging foreign investment while mitigating risks—demonstrates a commitment to creating a financial system that is transparent, resilient, and open. The nuanced approach ensures that while FPIs continue to bring in capital, they do so within a framework that prioritizes transparency and accountability. This dual focus on openness and vigilance is

critical for sustaining investor confidence and market stability.

Detailed BO Disclosure and Exemptions

SEBI introduced new regulations on beneficial ownership (BO) disclosure for FPIs investing in India. SEBI now requires FPIs meeting certain criteria to disclose the identity of all the people who ultimately own or control them, irrespective of the number of intermediate entities involved. This applies to FPIs with a majority of their Indian equity investments in a single corporate group or those with over ₹25,000 crore of equity AUM in India. SEBI wants to know who really controls the money being invested by certain large FPIs in India. This strengthens regulations around FPIs investing in Indian companies and ensures that the true controllers of significant investments are identified and held accountable.

Exemptions for Lower-Risk Entities

In August 2023, SEBI introduced stricter disclosure requirements for FPIs.⁷⁴¹ However, exemptions were carved out for specific categories deemed lower risk. Government and government-linked entities, public retail funds, exchange-traded funds with minimal India exposure, entities from established financial jurisdictions, and FPIs with a diverse range of investors were exempt. SEBI addressed a unique situation in March 2024 for listed companies without an identifiable promoter. To address this, an additional exemption was introduced for FPIs heavily invested in such groups with safeguards to mitigate potential risks. These exemptions demonstrate SEBI's understanding of the varying risk profiles among different investor categories and its effort to tailor regulations accordingly.

Strict Penalties for Non-Compliance

⁷⁴⁰ Stricter UBO disclosure norms for FPIs, KPMG, <https://kpmg.com/in/en/blogs/home/posts/2024/02/stricter-ubo-disclosure-norms-for-fpis.html> (last visited on 15th June, 2024)

⁷⁴¹ Sebi firm on FPI ownership norms as deadline looms, By Nishanth Vasudevan & Reena Zachariah, Economic Times, <https://economictimes.indiatimes.com/markets/stocks/news/sebi-firm-on-fpi-ownership-norms-as-deadline-looms/articleshow/107064243.cms?from=mdr> (last visited on 15th June, 2024)

SEBI's new disclosure rules for FPIs come with significant penalties for non-compliance. Failure to meet the detailed BO disclosure requirements could trigger severe consequences, including cancellation of the FPI's registration and forced exit from the market. This potentially disincentivizes long-term investments and disrupts portfolio management. However, a 10-day grace period for unintentional breaches allows for course correction, suggesting a balance between regulatory scrutiny and facilitating a business-friendly environment for compliant FPIs. This approach underscores SEBI's commitment to enforcing compliance while also providing a fair opportunity for rectifying unintentional lapses.

Future Outlook and Challenges

Looking ahead, the effectiveness of SEBI's enhanced regulations will largely depend on their implementation and the continuous adaptation to new financial technologies and practices. As financial markets grow increasingly complex, SEBI will need to employ advanced analytics and technology-driven solutions to monitor compliance effectively. Moreover, international cooperation will be crucial in managing cross-border investments and ensuring that global standards for transparency and disclosure are upheld. The dynamic nature of financial markets necessitates a regulatory framework that is not only robust but also flexible enough to adapt to emerging challenges.

Impact on Foreign Investment Climate

SEBI's rigorous regulations, while necessary for maintaining market integrity, could influence the foreign investment climate in India. By enforcing stringent disclosure requirements, SEBI aims to create a transparent and fair market environment. However, it is essential to strike a balance to ensure that these regulations do not deter genuine investors. Clear communication and efficient implementation of these rules will be vital in maintaining investor confidence. The focus should be on fostering an investment climate

that is both attractive to foreign investors and safe for all market participants.

Role of Technology in Compliance

The role of technology in ensuring compliance with SEBI's regulations cannot be overstated. Leveraging artificial intelligence (AI) and machine learning (ML) can help in identifying patterns and anomalies in investment behaviors that may indicate non-compliance or fraudulent activities. By integrating advanced technological solutions, SEBI can enhance its monitoring capabilities, making the regulatory process more efficient and effective. Technology can also assist FPIs in streamlining their compliance processes, reducing the burden of manual checks and documentation.

Conclusion

SEBI's enhanced FPI regulations are a testament to its commitment to maintaining a transparent, resilient, and trustworthy financial market in India. By focusing on rigorous KYC protocols, detailed BO disclosures, and targeted exemptions, SEBI aims to balance the influx of foreign investment with the need to safeguard market integrity. The future success of these regulations will depend on their effective implementation and continuous evolution in response to the changing financial landscape. With a proactive approach and a willingness to adapt, SEBI is well-positioned to navigate the complexities of global financial markets.