SEBI Taps Finance Ministry Over New Tag for Foreign Controlled Mutual Funds
written by Deiya Goswami | February 1, 2020

The October 2019 marked a new era in the Finance industry of the country as the new circular[1] regarding foreign controlled mutual funds issued by the RBI has included mutual funds with more than 50% foreign shareholding under the “investment vehicle” under the heading “Foreign Exchange Management (Mode of Payment and Reporting of Non-Debt Instruments) Regulations, 2019”. It is likely to jostle some of the large-scale mutual fund companies which are based in India. This is because this circular has tagged foreign controlled mutual funds that invest more than 50% in equity as investment vehicles. The alteration in the guidelines that foreign-owned funds being specified as investment vehicles is a clear contradiction of these regulations.

Previously, according to the rules and regulations in the SEBI Act, mutual funds are not subjected to any provisions related to money pooling or investment vehicles. But with the circular issued by the RBI on October 17, 2019, there is a paradigm shift in the scenario., It is pertinent to understand the concept of Mutual Funds. These are financial vehicles that pool money from various investors and invest the collected money in stocks, shares, short-term money-market instruments, or other securities or assets, or in form of permutation and combination of these investments.

“Mutual Fund means a fund established in the form of a trust to raise monies through the sale of units to the public or a section of the public under one or more schemes for investing in securities including money market instruments or gold or gold related instruments or real estate assets.”

The explanation behind such revamping is to make sure that the debt segment is controlled by the RBI, while the non-debt segment is regulated by the Central Government, thereby setting up a dual forex system for both debt and non-debt instruments.

These regulations specify the mode of payment and allowances on sale of proceeds incurred during buying or selling equity instruments of an Indian company by a Non-Resident Indian (“NRI”) or

Overseas Citizens of India (“OCI”) on the basis of repatriation; investments made by any person residing outside India; investment made by Foreign portfolio investors (“FPIs”); investment by other non-resident investors; investment in Limited Liability Partnership (“LLP”); investment by a Foreign Venture Capital Investor; investment by a person resident outside India in an Investment Vehicle; issue of Indian Depository Receipts.

FEMA (Foreign Exchange Management Act)

Under Foreign Exchange Management Act (“FEMA”) Rules in India, a certain cap has been specified on Foreign Direct Investment (“FDI”) or Foreign Indirect Investment (“FII”) sectors. FPIs, Foreign Funds or corporations are holders of large stakes in Indian Asset Management Companies (“AMCs”) that promote MFs, over which there were no bars on investment in any Indian listed companies. However, now, the RBI is of the belief that this kind of foreign dominance in the domestic AMCs, who in turn invest in the Indian companies, contravene with the FEMA norms since the indirect foreign holdings could be exceeding the specified caps constituted by it.

The definition of “investment vehicles” has been amended wherein mutual funds have been added. As per the new definition:

“investment vehicle means an entity registered and regulated under the regulations framed by the Securities and Exchange Board of India or any other authority designated for that purpose and shall include, namely:- (i) Real Estate Investment Trusts (REITs) governed by the Securities and Exchange Board of India (REITs) Regulations, 2014; (ii) Infrastructure Investment Trusts (InvIts) governed by the Securities and Exchange Board of India (InvIts) Regulations, 2014 (iii) Alternative Investment Funds (AIFs) governed by the Securities and Exchange Board of India (AIFs) Regulations, 2012; and (iv) mutual funds which invest more than fifty percent in equity governed by the Securities and Exchange Board of India (Mutual Funds) Regulations, 1996.”

If the investment manager or sponsor of a downstream investment is owned or controlled by a non-resident of India, then such investment by such funds through subscription or acquisition of shares will be considered as ‘indirect foreign investment’. This means that all the investment caps applicable under the FDI rules will now also be applicable to them as well. Earlier, FPI, alternative investment funds, real estate investment trusts, and infrastructure investment trusts were already in the list of investment vehicles and all the sectoral caps were applicable as per the FEMA norms.

For instance, under FDI norms, if a company is permitted 74% shareholding then any investment made in that company by a mutual fund with more than 50% foreign shareholding shall be taken in account under the 74% cap. Earlier, it was not computed under this cap and therefore, the MF company could freely invest in any company. As a result, numerous fund houses that have exceeded the prescribed cap might have to give away their holdings in companies dealing with foreign controlled mutual funds.

Moreover, all other regulatory provisions connected to monitoring, investment limitations, valuation and pricing criteria will also be applicable even though these MF schemes are primarily funded by indigenous retail capital. The fear is that various administrators of equity assets might discontinue investing and even sell their assets if they have already crossed the prescribed cap.

This will create undesirable obstacles for fund houses if they are to raise their stake in any script where foreign investment is already quite close to the highest sanctioned threshold as prescribed by the Reserve Bank of India. The constraints might also make it impossible for their ETFs (Exchange Traded Funds) to invest on the basis of the fundamental ratios as per the assigned weightage. It might pull back or stop the fresh money from coming into their investment schemes, which in turn invest in other mutual fund schemes, which is usually foreign funds.

According to the market watchers, in the regime when the government is relaxing the provisions for foreign investors, this kind of change in the regulations is at a variance of such initiatives and not at par with the expectations of the people of the country. This is because foreign investment by way of mutual funds is a very significant source that caters predominantly to domestic investors.

“Technically, the FDI regime does not apply to broad-based portfolio investments, even to those coming from outside India. It is applied to investments such as those made for a joint venture or for buying a company. Investments from a domestic broad-based mutual fund to get classified as an FDI is a misstep that needs to be resolved quickly,” a senior official from the Association of Mutual Funds in India (Amfi) said.

Some of the mutual fund companies which could be affected by this amendment in regulation because they have over 50% foreign ownership are namely Nippon India Mutual Fund, HDFC Mutual Fund, Principal Mutual Fund, ICICI Prudential Asset Management Co. Ltd., Mirae Asset Mutual Fund, Franklin Templeton, BNP Paribas, etc.

However, it is not clear that by what procedure the criteria of 50% equity will be arrived at for classifying the MFs as investment vehicles. According to experts, most likely, the total investment made in equity overall plans will be taken to calculate the equity portion.

Impact

As a consequence, mutual funds cannot invest in sectors where foreign investment is restricted, like tobacco, cigarettes, tobacco substitute manufacturing, casino gambling, and betting, etc.

Further, it will be very difficult for mutual fund houses to structure an arrangement to monitor the sectoral caps and report the same to the authorities timely because based on the market trades and the frequency of trades carried out by a company, the quantum of investment in an investee corporation might vary several times.

Conclusion

The new rules create a discrepancy between managers of domestic funds and foreign controlled mutual funds and act as an obstacle for foreign investors to enter into Indian markets. Foreign investment is very important as it heavily contributes to the economic growth and development of a country. This does not seem to be either radical or a major improvement over the previous regime rather it has lots of drawbacks and can be disastrous on the economic situation of the country.

However, these rules have relaxed the norms for Non-Resident Indians (NRI) and Overseas Citizens of India (OCI) who invest on a repatriable and non-repatriable basis as they have been given limitless permission to purchase or sell the units of domestic mutual funds. Although, they can only invest in those MFs wherein the MF has invested greater than 50% in equity of that company.

Amidst the ongoing concerns, mutual fund houses which will potentially be affected by this revamp in the guidelines have not till date fiddled with their respective portfolios as they have been assured by the regulator that their concerns will be considered and the matter regarding foreign controlled mutual funds will be looked into although, no update has been given yet.

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[1] https://www.rbi.org.in/Scripts/NotificationUser.aspx?Id=11736&Mode=0

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