New FEMA norms put foreign-held MFs in a bind

EQUITY ASSETS OF FUND HOUSES

	Equity assets (₹ crore)*	% of total assets**
Mirae Asset	28,121	84.5
Principal	4,214	61.6
BNP Paribas	3,235	44.3
Franklin Templeton	48,986	39.2
Invesco	8,870	37.7
Nippon India	63,137	31.0
HDFC MF	86,141	22.9
PGIM India	939	22.0
HSBC	2,602	21.5
ICICI Prudential MF	74,041	21.1

*for period ended September 30, 2019
**average AUM for quarter ended September 30, 2019
Note: Only equity, equity ELSS schemes are considered for computing equity assets
Sources: PRIME Database, Amfi

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A clutch of mutual fund (MF) houses — those that are either foreign-owned or controlled — may find themselves in a bind, following a tweak in the Foreign Exchange Management Act (FEMA) regulations a few days ago.

The Government of India notified new rules with regard to foreign investment in non-debt instruments on October 17, classifying MFs that invest more than 50 per cent in equity as 'investment vehicles'.

Until then, only real estate investment trusts, infrastructure investment trusts, and alternative investment funds were considered investment vehicles. Downstream investment by such funds by way of subscription or acquisition of shares will be considered 'indirect foreign investment' if their investment manager or sponsor is owned or controlled by a non-resident.

Such funds will have to adhere to the sectoral caps and restrictions currently applicable to foreign investment in Indian equities. This could put them at a significant disadvantage vis-à-vis domestic funds, limiting their investments in stocks with sectoral caps, and dragging down overall returns, said experts. Turn to Page 6 ▶

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The restrictions may also make it impossible for their exchange-traded funds to invest, according to the assigned weight of the underlying benchmarks, and put the brakes on fresh money coming into their fund of fund schemes, which invest in other MF schemes — typically international funds.

"Investment in Indian shares by MFs classified as investment vehicles, and where the sponsor or the investment manager is a foreign-owned or controlled company, shall be regarded as indirect foreign investment, and trigger compliance with FEMA sectoral caps, pricing, and reporting norms," said Tushar Sachade, partner, PwC India.

Franklin Templeton, BNP Paribas, Invesco, and Mirae Asset are among the seven asset managers identified as foreign by the Association of Mutual Funds in India (Amfi). Nippon India MF (formerly Reliance MF) has become the eighth foreign fund house after Nippon Life Insurance of Japan completed buying 75 per cent stake in the asset manager last month.

It is not clear if other fund houses such as HDFC MF or ICICI Prudential MF will also be considered to be foreign-controlled or owned, according to the FEMA definitions. Standard Life Investments, for instance, holds 29.94 per cent in HDFC MF for the quarter ended September 30, 2019. Another 52.76 per cent is held by Housing Development Finance Corporation, which itself is largely a foreign-owned entity, with 72.52 per cent held by foreign portfolio investors (FPIs).

Emails and text messages sent to officials of several of these fund houses did not immediately get a response. "We are assessing the situation and seeking a legal clarification on the issue," said Swarup Mohanty, chief executive officer, Mirae Asset MF.

"Today, I can have an overseas fund with foreign money investing in the domestic market and be treated as an FPI. However, if I am a domestic fund and the money is pooled from domestic investors, the investment will treated as foreign direct investment (FDI) and be subject to all kinds of restrictions just because the manager is foreign-owned. The intent of the notification is not clear and may lead to significant unintended consequences," added another senior fund official.

A fund's ability to invest in certain Indian stocks will be impacted, said Tejesh Chitlangi, senior partner, IC Universal Legal. "Banking stocks, for instance, have a 74 per cent FDI/FPI cap, and if this limit is exhausted, these funds will not be able to invest in them. Earlier, there was no such restriction," he said.

Let's say a foreign fund classified as an investment vehicle wants to buy shares of HDFC Bank, which caps foreign ownership at 74 per cent. Assuming the cap is breached, the foreign fund will not be able to make further purchases. Domestic funds, on the other hand, will be able to buy the bank's shares as they face no such restrictions.

Reporting norms will get triggered as well, leading to an increase in compliance requirements. MFs making downstream investments will have to notify the Department for Promotion of Industry and Industrial Trade and the Reserve Bank of India, within 30 days of investment, even if the equity instruments have not been allotted. The funds will also have to meet the applicable pricing guidelines and valuation norms at the time of making such investments.

"The reporting requirements for indirect foreign investment could be onerous and practically difficult to comply with. The ability of portfolio companies to raise foreign capital could be diminished as well, to the extent of investment by such impacted MFs," said Sachade.

To be sure, not all foreign fund houses may get immediately impacted by the change in FEMA norms. As of today, Mirae Asset and Principal MF are the two foreign fund houses with equity assets in excess of 50 per cent of the overall portfolio, the data from PRIME Database shows. This number ranges between 38 per cent and 44 per cent for BNP Paribas, Franklin Templeton, and Invesco. The actual percentage of equity assets for all the foreign-controlled fund houses, however, could be much higher if the equity portion of hybrid schemes, fund of funds, and other schemes are taken into consideration.

It is not clear how the 50 per cent in equity criteria will be arrived at for the purpose of classifying the funds as investment vehicles. "FEMA may take into account overall investment in equity across all schemes to compute the equity portion," said Chitlangi.