

CONSULTATION PAPER ON FACILITATING INVESTMENTS BY INDIAN MUTUAL FUNDS IN SUCH OVERSEAS FUNDS THAT INVEST CERTAIN PORTION OF THEIR ASSETS IN INDIAN SECURITIES

1. Objective

1.1. The objective of this consultation paper is to seek comments from public on the proposal of facilitating investments by Indian Mutual Funds in such Overseas Mutual Funds ('MFs')/ Unit Trusts ('UTs') that invest certain portion of their assets in Indian securities.

2. Background

2.1. As per the present regulatory framework, SEBI registered Mutual Funds are allowed to invest in the following eligible overseas securities for its overseas investment:

- 2.1.1. *ADRs / GDRs issued by Indian or foreign companies;*
- 2.1.2. *equity of overseas companies listed on recognized stock exchanges overseas;*
- 2.1.3. *initial and follow on public offerings for listing at recognized stock exchanges overseas;*
- 2.1.4. *foreign debt securities in the countries with fully convertible currencies, short term as well as long term debt instruments with rating not below investment grade by accredited / registered credit rating agencies;*
- 2.1.5. *money market instruments rated not below investment grade;*
- 2.1.6. *repos in the form of investment, where the counterparty is rated not below investment grade. The repos should not, however, involve any borrowing of funds by mutual funds;*
- 2.1.7. *government securities where the countries are rated not below investment grade;*
- 2.1.8. *derivatives traded on recognized stock exchanges overseas only for hedging and portfolio balancing with underlying as securities;*
- 2.1.9. *short term deposits with banks overseas where the issuer is rated not below investment grade;*
- 2.1.10. *units / securities issued by overseas Mutual Funds or Unit Trusts (MF/UTs) registered with overseas regulators and investing in (a) aforesaid securities, (b) Real Estate Investment Trusts (REITs) listed in recognized stock exchanges overseas, or (c) unlisted overseas securities (not exceeding 10 per cent of their net assets)."*

2.2. The above framework does not explicitly permit Indian Mutual Funds to invest in overseas MF/UTs with exposure to Indian securities. Therefore, it is understood that

many Mutual Funds in the industry avoid investing in such overseas MF/UTs that have any kind of exposure to Indian securities.

3. Need for such investments

- 3.1. Considering strong economic growth prospects of India, Indian securities offer an attractive investment opportunity for foreign funds. Accordingly, various international indices, exchange traded funds (ETFs), MFs, UTs allocate a portion of their assets to Indian securities.
- 3.2. For instance, as of April 30, 2024, the MSCI Emerging Markets Index has 18.08% weightage to Indian securities. Similarly, JP Morgan's 'Emerging Markets Opportunities Fund' holds approximately 15% in Indian investments, according to its latest factsheet as on March 31, 2024.
- 3.3. In order to diversify the portfolio, and as part of overseas fund of funds ('FoFs') schemes, the Indian Mutual Funds often invest in overseas securities including units of overseas MF/UTs, ETFs and index funds. However, ambiguity regarding investments in such overseas funds that may invest certain portion of their funds in Indian securities deters Mutual Funds from investing in those overseas MF/UTs, ETFs and index funds that invest in a basket of countries, which may include India.
- 3.4. In light of the above, there appears to be merit in considering to allow investment by Indian Mutual Funds in such overseas funds that have limited exposure to Indian securities. However, the same may be subject to careful consideration so as to address certain issues associated with these investments such as -
- Alignment with Fund Labels: If an overseas Fund of Funds (FoFs) offered by Indian Mutual Fund invests in overseas MF/UTs with a significant allocation to Indian securities, it may not be true to the fund's label, and may not reflect the overall purpose of investing in such FoFs.
 - Cost efficiency for end investors: Direct investment in Indian securities by an Indian investor would be cost effective rather than investing in Indian securities through an overseas Fund of Fund offered by Indian Mutual Funds.
- 3.5. Therefore, in order to facilitate investments in such overseas MF/UTs, it may be prudent to permit Indian Mutual Funds to invest in such overseas MF/UTs having certain limited exposure to Indian securities. Additionally, putting adequate safeguards for such investments would keep Indian FoFs true to their label as well as enable investors to take desired exposure in overseas securities.

4. Consultation with stakeholders and Mutual Fund Advisory Committee (MFAC)

- 4.1. In view of the above, discussions were held with industry body i.e. Association of Mutual Funds in India ('AMFI') and various Asset Management Companies ('AMCs').

The proposal, as detailed below, was also discussed in the Mutual Fund Advisory Committee ('MFAC').

5. Proposal

5.1. Based on the consultation with industry stakeholders and MFAC, a proposal on allowing investment by Indian Mutual Funds in such overseas funds that invest certain portion of their assets in Indian Securities, is as follows:

Investment by schemes:

5.2. The Indian Mutual Fund schemes may invest in such overseas MF/UTs that have exposure to Indian Securities, provided that the total exposure to Indian securities by such overseas MF/UTs shall **not be more than 20% of their net assets**.

Rationale:

The exposure of the MSCI Emerging Market Index (MEMI) to Indian Securities has shown a steady increase over the years, rising from approximately 8% in March 2018 to 15.88% in October 2023. Given the country's robust economic prospects, there can be further increase in allocation toward Indian Securities by overseas funds/indices. Thus, to strike a balance between facilitating investments in overseas funds with exposure to India and preventing excessive exposure, a limit of 20% is deemed appropriate.

5.3. While investing in such overseas MF/UTs, the Indian Mutual Fund schemes shall ensure the following:

5.3.1. **Pooling:** Contribution of all investors of the overseas MF/UT is pooled into a single investment vehicle, without presence of any side-vehicles.

5.3.2. **Pari-passu and Pro-rata:** Corpus of the overseas MF/UT shall be a blind pool (i.e. common portfolio) with no segregated portfolios. All investors in the overseas MF/UT shall have pari-passu and pro-rata rights in the fund, i.e. they shall receive a share of returns/gains from the fund in proportion to their contribution.

5.3.3. **Independent investment manager/fund manager:** Overseas MF/UT is managed by an officially appointed, independent investment manager/fund manager who is actively involved in making all investment decisions for the fund. This ensures that the investments are made autonomously by the investment manager/fund manager, without influence from the investors or undisclosed parties.

5.3.4. **Public disclosure:** Such overseas MF/UTs disclose their portfolios periodically to the public to maintain transparency.

5.3.5. **No advisory agreement:** There shall not be any advisory agreements between Indian Mutual Funds and underlying overseas MF/UTs, to prevent conflict of interest and avoid any undue advantage.

Breach of the limit:

- 5.4. If the exposure to Indian securities by the overseas MF/UT is above 20% at the time of making investment (both fresh and subsequent), it shall be considered as non-compliance with para 5.2 above.
- 5.5. Subsequent to the investment, if the exposure by an underlying overseas MF/UTs to Indian securities exceeds 20% of their net assets, an observance period of 6 months from the date of publicly available information of such breach (e.g. portfolio disclosures) shall be permitted to Indian Mutual Fund schemes for monitoring of any portfolio rebalancing activity by the underlying overseas MF/UT.
- 5.6. During the observance period, the Indian Mutual Fund scheme:
- 5.6.1. shall not undertake any fresh investments in such overseas MF/UT.
 - 5.6.2. may resume their investments in such overseas MF/UT in case the exposure to Indian securities by such overseas MF/UT falls below the limit of 20%.

Rebalancing of the portfolio:

- 5.7. If the portfolio of an underlying overseas MF/UT is not rebalanced within the 6-month observance period, Indian Mutual Fund scheme shall liquidate its investments in concerned underlying overseas MF/UT within the next 6 months ('liquidation period') from end of the observance period.
- 5.8. If the exposure to Indian securities by the underlying overseas MF/UT falls below the prescribed limit of 20% during the liquidation period, the requirement at clause 5.7 above shall not be applicable.

Non-compliance:

- 5.9. If the Indian Mutual Fund/ Asset Management Company fails to rebalance the portfolio of the scheme in line with the aforesaid requirements, then after the 6-month liquidation period, the Indian Mutual Fund/ Asset Management Company shall:
- 5.9.1. not be permitted to accept any fresh subscriptions in concerned Indian Mutual Fund scheme;
 - 5.9.2. not be permitted to launch any new scheme;
 - 5.9.3. not levy exit load, if any, on the investors exiting such scheme(s).

Rationale:

The above provisions are proposed in line with the SEBI Circular on 'Timelines for rebalancing of Portfolios of Mutual Funds' (ref. clause 2.9 of the SEBI Master Circular on Mutual Funds dated May 19, 2023) concerning passive breaches.

Applicability

5.10. The above proposal may be made applicable from the date of notification of Regulation/ issuance of Circular.

6. Consultation

6.1. In light of the proposal mentioned at paragraph 5 above, comments are sought in respect of the following:

- 6.1.1. Whether the limit of 20% as mentioned at para 5.2 is appropriate?
- 6.1.2. Whether passive schemes such as overseas ETFs, index funds etc. be excluded from the 20% exposure limit? If yes, whether Indian Mutual Funds should invest in such overseas passively managed funds which may have more than 20% exposure to Indian securities.
- 6.1.3. Whether the proposals regarding additional criteria for investment in overseas MF/UTs having exposure to Indian securities at para 5.3 is appropriate?
- 6.1.4. Whether the criteria for investment in overseas MF/UTs at para 5.3 should also include any specific parameter ensuring no concentration of investors in the underlying overseas MF/UTs?
- 6.1.5. Whether the proposals regarding breach of limit at para 5.4 to 5.6 are appropriate?
- 6.1.6. Whether the proposals regarding rebalancing of the portfolio at para 5.7 & 5.8 are appropriate?
- 6.1.7. Whether the proposal regarding non-compliance at paragraph 5.9 is appropriate?

Public Comments on this Consultation Paper

1. Public Comments

Public comments are invited for the proposals at paragraph 6 above. The comments/suggestions should be submitted by any of the following modes latest by **June 07, 2024**:-

- **Online web-based form**

- a) The comments may be submitted through the following link:
<https://www.sebi.gov.in/sebiweb/publiccommentv2/PublicCommentAction.do?doPublicComments=yes>
- b) The instructions to submit comments on the consultation paper are as under:
 - i. Before initiating the process, please read the instructions given on top left of the web form as “Instructions”.
 - ii. Select the consultation paper you want to comment upon from the dropdown under the tab – “Consultation Paper” after entering the requisite information in the form.

- iii. All fields in the form are mandatory;
 - iv. Email Id and phone number cannot be used more than once for providing comments on a particular consultation paper.
 - v. If you represent any organization other than the types mentioned under dropdown in “Organization Type”, please select “Others” and mention the type, which suits you best. Similarly, if you do not represent any organization, you may select “Others” and mention “Not Applicable” in the text box.
 - vi. There will be a dropdown of Proposals in the form. Please select the proposals one- by-one and for each of the proposal, please record your level of agreement with the selected proposal. Please note that submission of agreement level is mandatory.
 - vii. If you want to provide your comments for the selected proposal, please select “Yes” from the dropdown under “Do you want to comment on the proposal” and use the text boxes provided for the same.
 - viii. After recording your response to the proposal, click on “Submit” button. System will save your response to the selected proposal and prompt you to record your response for the next proposal. Please follow this procedure for all the proposals given in the dropdown.
 - ix. If you do not want to react on any proposal, please select that proposal from the dropdown and click on “Skip this proposal” and move to the next proposal.
 - x. After recording your response to all the proposals, you may see your draft response to all of proposals by clicking on “Check your response before submitting” just before submitting response to the last proposal in the dropdown. A pdf copy of the response can also be downloaded from the link given in right bottom of the web page.
 - xi. The final comments shall be submitted only after recording your response on all of the proposals in the consultation paper.
- c) In case of any technical issue in submitting your comments through web based public comments form, you may contact the following through email with a subject “Consultation paper on facilitating investments by Indian Mutual Funds in such overseas funds that invest certain portion of their asset in Indian securities.”:
- i. Mr. Peter Mardi, Deputy General Manager (peterm@sebi.gov.in)
 - ii. Mr. Rushikesh Vijay Bhopatrao, Assistant Manager (rushikeshb@sebi.gov.in)

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(End of Consultation Paper)