

Funds Hotline

April 10, 2010

FORMAL EMBARGO ON PROTECTED CELL COMPANIES AND SEGREGATED PORTFOLIO COMPANIES

On April 7, 2010 SEBI has issued instructions for filling FII and sub-account registration applications, which expressly prohibits the use of PCCs/ SPCs at any level for a FII/ sub-account registration. Also, fund entities set-up as Multi Class Vehicles shall qualify for registration only if certain stringent restrictions are complied with

The Securities and Exchange Board of India ("SEBI") has always shown apprehension in granting registration to off-shore entities structured as Protected Cell Companies ("PCCs") or Segregated Portfolio Companies ("SPCs"). Lately, SEBI was seen closely scrutinizing registration applications for entities structured as Multi Class Vehicles ("MCVs"), i.e., entities having the flexibility to issue multiple classes of shares under their constitution and their similarity with the PCCs or SPCs. Now, SEBI has in its recent guidance instructions issued on April 7, 2010 ("Instructions") for filling the Foreign Institutional Investor ("FII") and sub-account registration applications, made it mandatory for the applicants to make declarations that they are not structured as a PCC or a SPC. While, a carve out has been made for MCVs, subject to certain undertakings which *inter alia* include that common portfolios shall be allocated across various share classes and it shall be broad based or if portfolios are segregated for each distinct share class, then each such share class shall satisfy the broad based criteria. Further, issuance of any new class would require a prior SEBI approval.

Background

What are Protected Cell Companies/ Segregated Portfolio Companies?

Entities structured as PCCs or SPCs are widely used forms of fund vehicles in several jurisdictions, which provide for segregation of assets and liabilities of the investors by providing for distinct cellular assets, which can be in the form of a separate class of share or a dedicated sub-fund attributed to each investor investing into the fund vehicle. PCCs/ SPCs are statutorily authorized to segregate their assets and liabilities into cells thereby providing that a creditor of one cell can only proceed against the assets of that cell, a concept known as "*ring-fencing*". PCCs / SPCs also pay dividends with respect to the shareholders of a specific cell by reference only to the assets and liabilities attributable to that cell. For structural efficiency and for operational flexibility (for example managed accounts etc.) PCCs or SPCs are globally used as accepted structures.

What is a Multi Class Vehicle?

An entity structured as a MCV is a commonly used fund vehicle, having the flexibility to issue multiple classes of shares having differential benefits attached to them, so that each class has the ability to represent interest of a particular investor or for specific investments.

In other words, PCC and SPC have statutory recognition, whereas a MCV is a conventional entity having the flexibility to issue multiple classes of shares due to the powers granted in their constitutions / charter documents. MCVs can have contractual segregation of assets and liabilities *inter se* between shareholders of various classes, however, there is no segregation of liabilities *viz-a-viz* third parties and to that extent MCVs run a risk of cross-class liability *inter se* classes of shares or sub-funds.

Indian Securities Regulator's concern

The Foreign Institutional Investment route ("FII route") in India is heavily regulated and a foreign investor intending to make portfolio investments into Indian markets is required to seek prior registration with the SEBI under the SEBI (Foreign Institutional Investors) Regulations, 1995 ("SEBI FII Regulations"). The SEBI Regulations provides for the category of investors eligible for registration as FII or its sub-account and their eligibility criteria thereof.

Traditionally the FII route is restricted for sophisticated investors *viz*, financial institutions, banks, pension funds, endowments funds, sovereign funds, etc., or pooled funds managed by professional fund managers who are regulated by an appropriate foreign regulatory authority. With specific reference to funds managed by fund managers, there exists a specific category called a broad-based fund¹, which is eligible for registration as sub-account for making portfolio investments.

In a typical PCC / SPC structure, the fund vehicle has the inherent feature of representing distinct investment objectives, by adding separate units/cells or sub-funds to cater to the needs of different investors and provide the ability to the fund manager to market to a single fund having multiple investment strategies or different investors.

Despite satisfying the broad based fund criteria at the entity level, the fund vehicle has flexibility to pursue dedicated investment strategies for identified investors. The same in view of SEBI goes against the basic essence of a broad-based fund, as the investment does not represent the interest of all the investors, but of specific investors as per their

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investment strategy. Thus, SEBI had expressed concerns for fund vehicles structured as MCV, adding new classes of shares or sub-funds after seeking registration as a sub-account. Consequently, rightfully or wrongly SEBI also apprehends that such additional class of shares can be open to misuse for round-tripping.

Recent apprehensions

Towards the later part of last year, we noticed SEBI closely scrutinizing applications for granting registration to fund vehicles structured as MCVs and their applications were put on hold by SEBI. In fact, SEBI was seeking specific confirmations from fresh applicants as well as existing sub-accounts at the time of their renewal, to confirm if they are structured as a PCC or a MCV.

Later SEBI started granting registration to fund vehicles structured as MCVs, however, subject to certain restrictions viz.

- i. common portfolios are allocated across different class of shares and there should not be separate portfolios for distinct classes of shares; and
- ii. any inclusion of additional share class should have prior SEBI approval.

It is important to note that there was no specific restriction that each share class has to be broad-based, however, SEBI required the sub-accounts / FIs to intimate to them if the additional share class was not broad-based.

The additional conditions imposed at the time of grant of registrations brought the activities carried by MCVs under additional scrutiny. The restrictions acted as a deterrent for sub-accounts structured as MCVs for making dedicated investments on behalf for any particular investor by issuing a separate class of shares or for creating additional sub-funds within the same fund which may or may not be broad based per the SEBI definition.

The Instructions

As per the Instructions, the applications seeking to register themselves as FI or as sub-account to a FI are required to enclose the following declarations and undertakings on its letter head along with the application form.

“Declarations

Please tick whichever applicable.

- a) *The applicant declares that it is not a Protected Cell Company (PCC) or Segregated Portfolio Company (SPC) and does not have an equivalent structure by whatever nomenclature.*
- b) *The applicant declares that it is not a Multi Class Share Vehicle (MCV) by constitution and does not have an equivalent structure by whatever nomenclature. It contains only single class of share.*
- c) *The applicant declares that it is a MCV by constitution and has more than one class of shares or has an equivalent structure and that a common portfolio is maintained for all classes of shares and satisfies broad based criteria.*

OR

- c) *A segregated portfolio is maintained for separate classes of shares wherein each such class of shares are in turn broad based.*

Undertakings

In case the applicant is/ proposed to be a MCV or an equivalent structure and have more than one class of shares, it shall undertake the following on its letter head:

- a) *Common portfolios shall be allocated across various share classes and it shall be broad based;*

OR

- a) *If portfolios are segregated for each distinct share class, then each such share class shall satisfy the broad based criteria;*
- b) *In case of change in structure/ constitution/ addition of classes of shares, prior approval of SEBI shall be taken;*
- c) *In case of any addition of share classes, it shall follow the criteria at (a) above.”*

Analysis

The Instructions for the first time candidly communicate SEBI's stand on the granting registration to fund vehicles registered as PCCs and SPCs and their apprehension on fund vehicles structured as MCV, where the separate class of shares can be attributed for distinct investors. The key implications likely to surface are:

- i. Lack of flexibility: Pursuant to the undertaking in the registration application, the fund vehicle would lose the flexibility to dedicate separate class of shares pursuing different investment strategies for each investor, unless each scheme is broad based. This would also curtail the ability of the fund managers to market a single fund to multiple investors, and issue separate class of shares to meet the investment strategy requirements of specific investors.
- ii. Inability to offer shares on a non-discretionary basis: Instances where the class of shares of the investor was managed by the fund managers on a non-discretionary basis would be severely affected, when their application comes for renewal. SEBI would require a fresh undertaking from the sub-account that either common portfolios are maintained across each class of shares or each class should in-turn be broad-based. Such structures were akin to a portfolio management scheme in the domestic context.
- iii. Better surveillance by SEBI: The new policy would ensure only sophisticated investors are able to invest into India under the portfolio investment route. Where the fund is managed by accredited fund managers such manager would be required to ensure that the fund pursues a common investment strategy across all classes of shares and no specific class of share is created to benefit a particular investor.

Despite the good intentions, the Instructions can be said to be knee jerk reaction from SEBI in response to the recent findings of the SEBI in respect of some potential round tripping structures involving FII route and PCCs and SPCs. The reaction could severely impair the flexibility of fund managers globally who are managing accounts for various clients using such internationally accepted structures.

In fact, the “shot-gun” approach of the SEBI to deal with issues like round tripping etc, by putting such generic restrictions may communicate lack of maturity of Indian markets and regulators to deal with such issues in a more sophisticated and specific manner. Moreover, worldwide several new investment structures are gaining momentum, more specifically in respect of managed accounts, which may now face difficulty while seeking access to Indian markets due to the stringent policy of the Indian regulators. Needless to say, clarity and certainty are in some sense the right of an investor and frequently tinkering of the regulations may destroy investors’ confidence in the Indian markets.

¹For a fund entity to be regarded as ‘broad based’ fund, it should have at least 20 investors and none of them should hold more than 49% of the units or shares of the fund entity. However, if the fund entity has institutional investors then it shall not be necessary for the fund entity to have 20 investors. Further, if any institutional investor holds more than 49% of the units or shares of the fund entity, then the said institutional investor must itself be a ‘broad based’ fund. Thus, the definition of ‘broad based fund’ applies on a look through basis in case any investor holds more than 49% interest in the fund entity.

- **Shikhar Kacker & Divaspati Singh**

You may direct your comments to **Ramya Krishnan-Anil**

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Source: *SEBI Instructions for filling up registration application forms (Form A / Form AA) for Foreign Institutional Investors dated April 7, 2010*

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