

Sebi's proposal on P-Note regulations may have unintended legal issues, say experts

A Sebi decision prohibiting future investments by NRIs in Indian stock markets through P-Notes has sparked confusion over whether existing investments will be covered by the new rule



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Photo: Mint

Mumbai: A recent regulatory decision prohibiting future investments by non-resident Indians (NRIs) in Indian stock markets through participatory notes (P-Notes) has sparked confusion over whether existing investments will be covered by the new rule. The proposed changes may also have some un-intended consequences, legal experts said.

Overseas investors who wish to buy Indian stocks but do not want to register themselves with the Indian market regulator often buy P-Notes, which are offshore derivative instruments (ODIs) sold by registered foreign portfolio investors (FPIs) with underlying Indian stocks. These are generally seen to be opaque structures offering anonymity to the investors. After the finance ministry in February sought greater restrictions on use of P-Notes, the board of Securities and Exchange Board of India (Sebi) on 26 April decided to shut this route by amending regulations for FPIs.

Inflows via P-Notes stood at Rs1.78 trillion in March. As a percentage of total inflows from foreign portfolio investors (FPIs), it, however, was unchanged from February's 6.6%.

Even though Sebi had previously expressed its dislike for NRIs using the P-Note route in its frequently asked questions (FAQs) issued in September 2016 to clarify FPI regulations, such investments weren't prohibited.

"There is no validity in a prohibition being imposed through a FAQ. Any law prohibiting such investments has to be imposed after going through due process of the law. The obvious question, of course, will be how old investments by NRIs are to be tackled with the new rules barring usage of P-Notes. Should it be through a time frame given to NRIs to unwind their investments or something more drastic?" said Sandeep Parekh, founder of Finsec Law Advisors.

Sebi did not respond to an email seeking comment.

FPIs which follow Sebi regulations, circulars and FAQs have always maintained that allowing NRIs access to Indian markets through the P-Notes route was illegal or atleast frowned upon. However, violations (which were not technically illegal so far because they were not in the rule book) could now be contested, with the rule coming in with prospective effect. However, previous use of P-Notes cannot be termed illegal as it was not covered by the law then.

The text of the FAQ to Sebi (Foreign Portfolio Investors) Regulations, 2014 itself begins with a disclaimer that the FAQs are prepared with a view to guide market participants on the regulation. Sebi has, however, been of the view that it can interpret its own regulations in the form of FAQs.

"The prohibition on issuance of ODIs to NRIs has historically been there as a part of an undertaking contained under monthly ODI reporting format notified by way of a Sebi circular, hence having legal enforceability," said Tejesh Chitlangi, partner, IC Legal.

FPIs have to report their positions in ODIs to Sebi at the end of every month.

"To amend the FPI regulations whilst giving an impression that previously it was a grey area with respect to NRI purchasers may lead to unintended legal issues," Chitlangi added.

Richie Sacheti, head of investment funds practice at Nishith Desai Associates, agrees that the majority of FPIs were already following this practice.

"The proposal seems to restrict entities that are beneficially owned by NRIs from subscribing to ODIs. While we will await the actual text of amendment to the regulations, the proposal seems to be in line with the current practice followed by some of the leading issuers as part of

their side letters," said Sancheti.

"Much remains to be seen on how the amended regulations are worded and whether Sebi will grandfather any earlier issues of P-Notes to NRIs/resident Indians. However, given the view expressed in the FAQ followed by the proposed change, such grandfathering appears to be unlikely," said Suresh Swamy, partner, Price Waterhouse Coopers. Grandfathering here refers to protecting previous investments, while prohibiting future ones.

Sebi, as a practice, issues FAQs to clarify its own regulations. Even in the case of FPI regulations, Sebi has issued at least three sets of FAQs.

The other FAQs issued by Sebi also state that they offer only a simplistic explanation or clarification of terms and concepts related to the regulation and it should not be treated as law.