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Watchdog tightens offshore derivative rules to stem illegal money inflow

MUMBAI (NewsRise) -- India has tightened rules on offshore derivatives, as it seeks to plug potential sources of illegal money flowing into the nation's financial markets.

The Securities and Exchange Board of India, in line with recommendations from a panel on black money appointed by the nation's top court, on Thursday tightened the so-called "know-your-customer norms" by asking issuers of offshore derivative instruments to identify and verify the beneficial owners of entities holding such instruments.

The regulator also said subscribers of the derivative instruments will now have to take prior permission from issuers before transferring the instruments and required the issuer to provide a complete transfer trail to the capital regulator an a monthly basis.

Prime Minister Narendra Modi's administration has been ramping up measures to clamp down on illicit cash flowing into financial markets. Last May, parliament approved The Undisclosed Foreign Income and Assets and Imposition of Tax Act, 2015, to help enact stricter rules to track down on the so-called black money.

Earlier this month, the federal government announced plans to impose a capital gains tax on investments from Mauritius from April 1, 2017. Inflows from the island nation have been tax exempt since 1983, but the agreement between the two countries has led to money laundering and "round-tripping" - the practice of Indian money stashed away abroad coming back as foreign capital via tax havens.

Offshore derivatives instruments, which include the popular Participatory Notes, or P-Notes, are issued by SEBI-registered entities to overseas investors seeking to access India's capital markets without any registration.

"Several institutional swap dealers dealing in Indian products were already in-compliance with most of the revised directives, since they have been engaging with SEBI and incorporating their feedback in their ODI issuance program," said Richie Sancheti, Head, Investment Funds, Nishith Desai Associates. "With this step to formalize some of these rules, SEBI brings about a greater uniformity for all ODI issuers under the ambit of the Indian KYC norms."

Authorities have long-feared that keeping private the identity of the eventual beneficial owners has prompted the use of these derivative products for money laundering and round-tripping.

Sancheti said P-Notes and other classes of over-the-counter (OTC) derivatives allow the subscriber a streamlined basis for accessing several markets while dealing with very limited number of counterparties. With these norms now a part of the regulatory framework, the Indian regulators should be comfortable with both the forms of market access, he said.

In July last year, an appointed panel recommended that SEBI review the rules pertaining to the P-Notes, sparking a selloff in Indian equities on concerns that the move will affect the flows of foreign funds to India.

"The move by the regulator is a positive development as it increases the transparency related to the foreign fund flows and will prevent the flow of black money form unknown entities," said G. Chokkalingam of Equinomics Research and Advisory. "The stringent KYC requirements may make the P-note route a lot more cumbersome and likely lead to fall in investments via this route."

India's benchmark BSE Sensex fell 0.39% on Thursday in Mumbai.

Economic Affairs Secretary Shaktikanta Das sought to allay investor concerns, saying on Twitter Thursday that P-Notes account for only 10% of the assets under custody of foreign portfolio inflows now, compared with 56% in 2007.

"SEBI Board's decision on P-Notes will add strength to our markets. Genuine investors and p-note holders will find it easy to comply," Das said.