Funds Hotline

January 21, 2010

SEBI PULLS FII FOR MISSTATEMENT IN ODI DISCLOSURES

In a recent investigation, the Securities and Exchange Board of India ("**SEBI**") has come across apparent discrepancies with respect to the disclosures filings made for issuance of Off-shore Derivative Instruments ("**ODIs**") by Societe Generale ("**SG**") to its counterparties. Accordingly, SEBI has *vide* its order dated January 15, 2010 ("**SEBI Order**") restrained SG from trading in ODIs and has also issued a show cause notice to SG, as to why appropriate proceedings including cancellation of its certificate of registration as a Foreign Institutional Investor ("**FII**") should not be initiated.

The said SEBI Order has come into force with immediate effect.

Before we discuss the case and the SEBI Order, we would briefly like to explain what are offshore derivative instruments and the regulations governing thereof.

What are Offshore Derivative Instruments?

SEBI (Foreign Institutional Investor) Regulations, 1995 ("**SEBI FII Regulations**") define ODI to mean any instrument, by whatever name called, which is issued overseas by a foreign institutional investor against securities held by it that are listed or proposed to be listed on any recognised stock exchange in India, as its underlying. The common examples of ODI are, Participatory Notes ("**P-Notes**"), swaps etc.

Currently, the SEBI FII Regulations permit FIIs to issue ODIs, subject to fulfillment of two conditions.

"Conditions for issuance of offshore derivative instruments.

15A. (1) No foreign institutional investor may issue, or otherwise deal in offshore derivative instruments, directly or indirectly, unless the following conditions are satisfied:

a. such offshore derivative instruments are issued only to persons who are regulated by an appropriate foreign regulatory authority;

b. such offshore derivative instruments are issued after compliance with 'know your client' norms:

……

(2) A foreign institutional investor shall ensure that no further issue or transfer is made of any offshore derivative instruments issued by or on behalf of it to any person other than a person regulated by an appropriate foreign regulatory authority."

Further, as per Regulation 15A, person regulated by an appropriate foreign regulatory authority means and includes the following:

i. any person that is regulated/supervised and licensed/registered by a foreign central bank;

ii. any person that is registered and regulated by a securities or futures regulator in any foreign country or state;

iii. any broad based fund or portfolio incorporated or established outside India or proprietary fund of a registered foreign institutional investor or university fund, endowment, foundation, charitable trust or charitable society whose investments are managed by a person covered by clauses (i), or (ii) above.

Additionally, the SEBI FII Regulations were amended in May 2008, and required that in cases where any person other than a person regulated by an appropriate foreign regulatory authority is holding ODIs issued by or on behalf of the FII, the FII is required to ensure that they are cancelled, redeemed or closed out, before the March 31, 2009.

Disclosure requirements for ODI issuances

As per Regulation 20A of the SEBI FII Regulations, FIIs are required to fully disclose information concerning the terms of and parties to ODIs such as P-Notes, Equity Linked Notes or any other such instruments, by whatever names they are called, entered into by it or its sub-accounts or affiliates relating to any securities listed or proposed to be listed in any stock exchange in India, in the format prescribed by SEBI.

Further, as per SEBI Circular No. IMD/FII & C/ 28 /2008 dated May 27, 2008, FIIs are required to furnish an undertaking along with respect to the monthly reporting of ODIs as follows:

"We undertake that we/ our associates have not issued/ subscribed/ purchased any of the offshore derivative instruments directly to/ from Non Resident Indians/ Indian Residents."

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Adherence to code of conduct

Regulation 7A of the SEBI FII Regulations provides for FII holding a certificate of registration to adhere to the Code of conduct as specified under Schedule III of the SEBI FII Regulations.

"Code of conduct,

7A. A foreign institutional investor holding a certificate shall, at all times, abide by the Code of Conduct as specified in Third Schedule."

Clause 6 of the Code of Conduct inter alia prohibits an FII to make any untrue statement. Clause 6 is reproduced hereinbelow:

"6. A Foreign Institutional Investor shall not make any untrue statement or suppress any material fact in any documents, reports or information furnished to the Board"

Brief facts of the case

SG is registered with SEBI as a Foreign Institutional Investor ("**FII**") under the SEBI FII Regulations.

On December 15, 2009 SEBI had asked SG to submit information in respect of ODIs issued to Hythe Securities Limited ("**Hythe**"), during the period between January 2006 and January 2008, which had Reliance Communications Limited ("**Rcom**") scrips as underlying. SG was also directed to provide documents in support of the transactions with Hythe and any onward issuance of ODIs.

SG, in its reply e-mail dated December 24, 2009 acknowledged inaccuracy in its monthly ODI reporting to SEBI of the transactions with Hythe. During its investigation, it was observed by SEBI that SG had forty eight (48) transactions with Hythe out of which fourteen (14) transactions were admittedly misreported.

Principal agent relationship between SG and Hythe?

During its investigation, SEBI emphasized to ascertain the ultimate beneficiary of the ODIs issued by SG, therefore, it sought details of the relationship between SG and Hyde, so as to ascertain if Hyde was the ultimate beneficiary of ODIs and was acting in its capacity as a principal, and not as an agent for the onward issuance of the ODIs.

In this regard, SG contended that based on the dealing, booking instruction and settlement of Hythe, it had concluded that Hythe was acting as a principal and the beneficial owner of the transactions. SG further stated that, though Hythe had mentioned the word 'client' during one of its conversations, it did not indicate the ultimate beneficial owner and the said transaction took place in the same manner as other transactions with Hythe, i.e. Hythe acting as a principal and being the ultimate beneficiary.

SEBI during its investigation and during scrutinizing the documents submitted by SG in support of its relationship with Hythe amongst other documents, SG had also provided a document dated March 8, 2006 addressed to Hythe containing certain acknowledgements, representations, warranties and undertakings in respect of the ODIs. One of the clauses of the said document was the specific clause quoted herein below:-

"Upon our request, you will promptly provide us or procure such information as is requested or required by the Issuer and/or any statutory or regulatory authority directly or indirectly connected with the issue, offer, sell, transfer, assignment, novation or otherwise creating any economic interest against the Products either by you and/or your affiliates and/or your associates (including pursuant to the securities laws or regulations as may be applicable)"

Despite, having rights to seek information from Hythe in respect of any onward issuance of ODIs, however, SG in its email informed SEBI that they

"will dispatch the request via e-mail today to Hythe to provide directly to SEBI to preserve Hythe's client confidentiality (we will provide your email address to the Compliance Department of Hythe)

- confirmation that Hythe is the end beneficiary of all the above transactions, and

- to the extent that Hythe is not the end beneficiary owner of any such transactions, the details of end beneficiary owners of such transactions…"

Hythe's response

Consequent to SG's response, SEBI received an email dated January 7, 2010 from Hythe, requesting to confirm the veracity of request for information on ODIs and also confirm that it is a "compelled regulatory request". Thereafter, Hythe vide another e-mail dated January 11, 2010 confirmed that it had acted as broker in those transactions. It was noted by SEBI that those ODIs had been onward issued to Opportunite S.A. (Registered FII: IN-FR-FD-1387-06) and further to "designations" by the name of Pluri Emerging Co PPC Cell E, Pluri Cell E, or just Cell E.

SG's inability to furnish information in respect of the ODI activity

Under the SEBI FII Regulations, the onus lies on the FII issuing ODIs to ensure that ODIs are issued only after carrying out necessary KYC check and ensuring that no onward issuance of ODI is made to an unregulated entity. As regards the onward issuance of ODIs, SG has stated that the agreements signed by it with Hythe provided an ability to it to seek information on the end beneficiary owner of the ODIs, so issued. However, SG acknowledged that it was unable to obtain the details of beneficial owners stating *"Hythe is not willing to provide such information to us. They would rather provide you (SEBI) the details directly."*

Thus, at two instances, SG expressed its unwillingness and inability to furnish necessary details relating to ultimate beneficiaries of the ODIs issued by SG to Hythe.

SEBI rationale for the Order cum Show Cause Notice

SEBI in its order observed that, SEBI has permitted issuance of ODIs by FIIs with an explicit obligation that it is the responsibility of the FIIs issuing ODIs/ to maintain complete audit trail of onward issuances of ODIs right up to the end beneficiary.

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From the conduct of SG, SEBI concluded that SG had not only failed to carry out proper KYC norms and abide with the provisions pertaining to issuance of ODIs under the SEBI FII Regulations, SG also shirked the responsibility cast on it under the SEBI FII Regulations, and has left it to its subscriber- Hythe, which is not registered and regulated by SEBI, to furnish the necessary information. FIIs shall also bear the responsibility of reporting the same to SEBI in their monthly reports.

SEBI stated that SG should have sought information relating to the ultimate beneficiaries of the ODIs subscribers in the first instance, before issuance of ODIs. SEBI stated that SG has not been able to maintain any meaningful control over its processes/systems for identifying the ultimate beneficial owners, in compliance with the stipulations imposed under law thus demonstrating complete disregard for the regulatory compliance expected from SG in its capacity as FII and an issuer of ODIs.

Thus as per SEBI:

a. SG has failed to provide true, fair and complete details of the ODIs activity undertaken by it but also prima facie violated the provisions of SEBI FII Regulations by furnishing false and incorrect information to SEBI.

b. It prima facie, has not even been able to ascertain whether the entity to which ODIs were issued onward are themselves regulated.

c. It has failed in its due diligence expected in the observance of 'know your client' norms.

Accordingly, SEBI directed SG not to issue/subscribe or otherwise transact in any fresh/new Offshore Derivative Instrument till such time it provides a true and correct reporting of its ODIs, to the SEBI.

Furthermore, in light of the aforesaid *prima facie* violations, required SG to show cause as to why appropriate proceedings including cancellation of its certificate of registration as a FII should not be initiated.

Societe Generale can file its objections/reply, if any, to this SEBI Order, within thirty days. The fate of SG would be decided pursuant to submissions made with SEBI on or before February 15, 2010.

NDA Analysis

ODI from its nature being traded in an off-shore jurisdiction are outside the regulatory purview of Indian regulators, therefore, every attempt has been made by SEBI that ODIs are issued only to regulated entities, as from their perspective in case of any malfeasance on behalf of any such ODI holder, SEBI may approach regulator of such entity directly. Bearing this in mind, the SEBI FII Regulations were amended prohibiting sub-accounts, which are essentially unregulated entities, from issuing ODIs and requires the FII to ensure that ODIs are issued only to Person regulated by an appropriate foreign regulatory authority and after complying with proper KYC norms. The amendment also imposed an additional responsibility on the FII to ensure that no back-to-back ODIs are issued by the subscriber of ODI to a person who otherwise would not have been able to subscribe to ODIs issued by it.

It can be argued that, though FII has a statutory obligation under the SEBI FII Regulations to ensure that ODIs are not issued to any unregulated entity, however, the FII can seek information from the its ODI subscribers, only by virtue of a contractual obligation, therefore, any misrepresentation or breach of the contractual violation would merely entitle the FII to wind-up the ODI or seek civil remedy outside the jurisdiction of India. However, FII cannot take any preventive measures, in the event misrepresentation is made by ODI subscribers.

Our recommendation

i. Minimum KYC guidelines: SEBI should provide for minimum KYC Guidelines that an FII must adhere to, because the present guidelines are too vague and generic.

ii. SEBI should provide for check-list to be submitted with the Stock Exchange, for transfer of ODIs listed on the floor of overseas stock exchange: At the time of onward issuance of ODI, the subscriber should be required to submit a check-list with the overseas stock exchange, disclosing the mandatory details about the beneficiaries of the ODIs. This would ensure that the overseas stock exchanges have relevant details of the ultimate beneficiaries of the ODIs, issued by the FIIs.

iii. Stricter transfer provisions under the ODI contracts: FIIs issuing ODIs should include stricter transfer provisions in their ODI contracts whereby it is made obligatory on the ODI holder to take a prior permission of the FII before transferring such ODI.

Source: Sebi Order dated January 15, 2010

Shikhar Kacker and **Divaspati Singh**