Corpsec Hotline

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SEBI'S CLAMP DOWN ON OFFSHORE DERIVATIVE INSTRUMENTS?

Yesterday, Securities and Exchange Board of India ("**SEBI**") issued a discussion paper on proposed policy measures on much talked about topic of Offshore Derivative Instruments ("**ODIs**") in recent times given the sustained upsurge in the Indian capital markets. The underlying reason, as stated in the discussion paper, for the proposed measures is to address the concern of the Government and the regulators such as Reserve Bank of India and SEBI in respect of increased inflows in to India through ODIs over the recent years and the associated anonymity with the instrument. To put the concerns in a context, the discussion paper mentions that the notional value of ODIs outstanding which was at Rs.31,875 crores (approx. USD 8 billion) (20% of AUC[1]) in March 2004 has grown to Rs.3,53,484 crores (approx. USD 88 billion) (51.6% of AUC) by August 2007.

The said discussion paper is open for comments till 20 October 2007 beyond which SEBI will formulate its final view and is likely to finalise the guidelines in relation to the ODIs. The proposed policy measures are as follows:

1. FIIs and their sub-accounts shall not issue/renew ODIs with underlying as derivatives with immediate effect. They are required to wind up the current position over 18 months, during which period SEBI will review the position from time to time.
2. Further issuance of ODIs by the sub-accounts of FIIs will be discontinued with immediate effect. They will be required to wind up the current position over 18 months, during which period SEBI will review the position from time to time.
3. The FIIs who are currently issuing ODIs with notional value of Participatory Notes (PNs) outstanding (excluding derivatives) as a percentage of their AUC in India of less than 40% shall be allowed to issue further ODIs only at the incremental rate of 5% of their AUC in India.
4. Those FIIs with notional value of PNs outstanding (excluding derivatives) as a percentage of their AUC in India of more than 40% shall issue PNs only against cancellation / redemption / closing out of the existing PNs of at least equivalent amount.

To understand the context in which the above policy measures are now being proposed, it may be appropriate to briefly understand the historical measures SEBI has taken to regulate ODIs. The erstwhile FII guidelines enacted in 1992 and FII Regulations enacted in 1995 laid down eligibility criteria for registration as an FII. There are strict eligibility criteria laid down for registration as a FII and those overseas entities that did not satisfy the eligibility criteria took exposure to Indian securities through ODIs. However, the exposure through ODIs, as a concept, was still developing and was not widely preferred mode of investing due to costs involved and complicated nature of the product itself. Also the size of the Indian markets combined with the above restrictions did not enthuse many foreign investors to go through the pains of either registering themselves or use expensive instruments such as ODIs for investing in India. Over the following years, as the markets grew in size and the economy became fundamentally attractive as an investment destination, more and more investors looked at Indian markets and were willing to take an exposure through ODIs. As portfolio investments through ODIs increased coupled with volatility in stock markets, SEBI realized the role played by ODIs and felt the need to put some regulatory mechanism to keep track of it, which resulted in issuance of circular dated October 31, 2001 whereby SEBI directed FIIs to submit fortnightly reports of issuance/renewal/cancellation/redemption of ODIs. The frequency of this reporting was changed to monthly basis in terms of circular dated August 08, 2003. To give it a statutory power, SEBI amended the FII Regulations on August 28, 2003 as a result of which it got wide powers to ask the FIIs and sub-accounts to disclose information on the terms of and parties to ODIs as and when required by SEBI. Subsequently, SEBI, pursuant to the recommendation of the technical committee, by way of a circular dated February 13, 2004 issued a list of regulatory bodies and mandated that ODIs could be issued only to entities that are regulated by any of the listed regulators in their home country. Further, the experience of the regulators in the UBS case in 2004, seemed to strengthened the view of the regulators regarding the opaqueness of the ODI instruments and their impact on the volatility of the markets. Therefore, in a nutshell the proposed policy measures are as such in line with the proactive steps taken by SEBI since early 2000 onwards towards tightening of investments through ODI route.

Impact and Analysis

- The timing of the proposed guidelines seems to indicate that SEBI has now opened up an avenue for hedge funds to register directly as they appear to be the primary users of the ODIs. Thus, this may be in some form viewed to be

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a communication to the hedge funds to come forward and register themselves and invest in a form which the regulators believe is more transparent. It could also indicate that with a view to negate the effect of the proposed measures, SEBI may also consider further relaxations to the FII/sub-account eligibility criteria to enable a larger universe of investors to be able to invest directly as FII or sub-account.

- The restrictions under the proposed policy on issuance of ODIs linked to underlying derivatives seem to be coming from the fact that the regulators are concerned with the use of leverage by FIIs and increased exposure of FIIs through ODI linked to derivatives provided an indirect form of leverage. Further, the derivative markets as against being a hedging opportunity were themselves turning into a speculative market which is not desirable considering its indirect impact on the cash segment. SEBI has shared the information on this aspect - the value of outstanding ODIs with underlying as derivatives currently stands at Rs. 1,17,071 crores (approx. US$ 29 billion), which is approximately 30% of total ODI outstanding. Having said this, the 18 month period provided for winding up their positions appear reasonable and may cushion the impact on the market to a certain extent.
- It also appears that SEBI is more comfortable with the FIIs themselves issuing ODIs as against sub-accounts since the FIIs are directly regulated by SEBI and more accountable as against the sub-accounts. This could also have been targeted to those sub-accounts which were otherwise using third party FIIs wherein the FIIs did not have sufficient control over the operations of the sub-account.
- Further, those FIIs which have ODI exposure of less than 40% of the AUC in India are allowed to incremental increase of 5% of their AUC in India. This essentially implies that such FIIs may not be able to straightaway increase their exposure to the extent of the head room available and will be required to increase their AUC in India through direct participation with a view to increase the ODI exposure. This will avoid the situation of roll over of excess exposures from one FII to the other which would have negated the reduced ODI exposure objective of the proposed measures.
- There is a question mark as to whether those FIIs which have covered their ODI exposures through sub-accounts organized in tax favorable jurisdictions will now be forced to hedge their exposures directly and if so, if the FIIs are themselves not located in a treaty jurisdiction there could be potential adverse tax consequences on their exits.
- Interestingly the existing FIIs who have an exposure in excess of 40% of the AUC in India have not been forced to reduce their exposure. However, they may not be able to increase their exposure except against redemption/cancellation/closing out of ODIs already issued. This may put them in a slightly advantageous position vis-a-vis those FIIs which do not have the ODI exposure or have less than 40% exposure. Also it seems to suggest that for new FIIs, the amount of ODI exposures that they may be able to create will be restricted to 5% of their AUC in India.

Conclusion

In our view, if the said measures are implemented in the current form, while in the short term this may create some volatility and nervousness in the market, in the long run this could end the uncertainty surrounding the ODIs and could potentially lead to more transparent and efficiently regulated market. Also, with the hanging sword of ODI behind them, hopefully SEBI may be more open to introduce further reforms to the FII regime such as NRI/OCB participation issue, foreign corporate/foreign individual sub-accounts, etc.

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1 Assets Under Custody of all FIIs/Sub Accounts in India

Source: Paper for discussion on Offshore Derivative Instruments (Participatory Notes)

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You can direct your queries or comments to the authors

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