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Tightening the noose: Sebi cracks the whip on p-notes

Fees of $1,000 per subscriber and ban on speculative derivatives trades among measures proposed

Pavan Burugula | Mumbai May 30, 2017 Last Updated at 08:37 IST

The logo of the Securities and Exchange Board of India (SEBI) is pictured on the premises of its headquarters in Mumbai (Photo: Reuters)

The Securities and Exchange Board of India (Sebi) on Monday proposed tighter regulations for participatory notes (p-notes), an instrument used by foreign investors to take exposure to the domestic market without registering in India.

In a discussion paper, the market regulator proposed to bar p-notes, or offshore derivative instruments (ODIs), from taking speculative positions in the futures and options segment. It said note-holders would be allowed exposure to the derivatives market only for hedging and not for naked speculation.

The ban on derivative trades without underlying equity could impact nearly a third of ODI subscribers, who currently deal only in derivatives, say experts. A large number of investors also deal in both cash and derivatives, but don’t use derivatives for hedging purpose.

“Through these changes, Sebi is trying to curb the volatility in the F&O market that emanates through ODIs. This, however, should not impact participants whose investment strategies allow for correlation between their positions in the cash segment vis-à-vis their positions in the F&O segment. For strategies that access F&O markets without underlying exposure, the only option seems to be to roll over to the FPI programme," said Richie Sancheti, head of investment funds practice, Nishith Desai Associates.

The restrictions on the derivatives trade could also curb tax evasion, said legal experts.

"Many ODI subscribers have been shifting to derivatives since the amended tax treaties came in effect. These proposed changes by Sebi would plug such transitions," said Rajesh Gandhi, partner, Deloitte.

Sebi also proposed to levy regulatory fees of $1,000 (Rs 65,000) on every ODI subscriber. The fees will be levied on the foreign portfolio investor (FPI) issuing the p-note. The fees were aimed at encouraging registration of FPIs, Sebi said.

"This is a move to reduce speculative trading by overseas funds. The move is bound to have some impact on ODI investments. But the contribution of p-notes to total derivatives is low," said Bhavin Shah, financial services tax leader, PwC.

According to experts, the average ticket size of a p-note investor is around $20-25 million and there are about 1,500 ODI subscribers. The regulatory fee could make p-notes costly for this class of investors.

At the end of last month, outstanding p-note investments in derivatives stood at Rs 40,165 crore (notional value), which was nearly a fourth of the total outstanding p-note investments. According to industry estimates, 15 per cent of the total exposure of foreign investors in Indian derivatives is through p-notes. This is much higher than p-note share in overall FPI investment, which is around 6 per cent.

If the proposed norms are implemented, Sebi said p-note holders would be given time till December 31, 2020, to wind up existing positions. Sebi said the onus for ensuring that note-holders' use of derivatives only for hedging would be with the FPI issuers. Experts said monitoring this could be a difficult.

Fears of routing of black money and round-tripping prompted Sebi to tighten p-note rules in the last couple of years. In 2016, Sebi increased the know-your-customer requirements, issued curbs on transferability and prescribed stringent reporting for p-note issuers and holders. It also mandated issuers to follow Indian anti-money laundering laws.

The tightening of rules has dulled the appeal of p-notes, with the share of the instrument declining from a peak of 50 per cent in 2007 to 6 per cent at present. The regulator has invited comments on the new proposals till June 12.