Paper for discussion on Offshore Derivative Instruments (Participatory Notes)

Objective

This paper sets out the proposed policy measures on Offshore Derivative Instruments (Participatory Notes).

Background

With a view to monitoring the investment by FIIs through Offshore Derivative Instruments (ODIs) such as Participatory Notes (PNs), Equity Linked Notes, Capped Return Notes, Participating Return Notes etc., SEBI had prescribed reporting of issuance / renewal / cancellation / redemption of the ODIs on a monthly basis since October 2001. The figures submitted by the FIIs on a month to month basis showed an increasing trend.

In the latter half of 2003, a Technical Committee of SEBI Regulated Entities was constituted by the HLCCFM to examine the issues pertaining to P-Notes more closely. The Committee, comprising representatives of RBI, IRDA, SEBI and NSE met in October, 2003 and extensively discussed the issues like :

- Whether PNs should be allowed to be issued at all,
- Whether restrictive use of PNs is possible,
- Monitoring of compliance
- Phasing out of PNs that are non-compliant with new restrictions, etc

The Committee, having examined the concerns raised by the participants, felt that while these issues and concerns would have to be addressed in the interest of the market, the measures taken should be practical, pragmatic, non-disruptive and enforceable without great difficulty. Recognizing that it may be difficult to enforce a complete ban on PNs, the Committee made certain recommendations which included issuance of PNs only to regulated entities subject to KYC requirements. The same was implemented through suitable amendment to FII regulations.

However, the year on year increase in ODIs, the anonymity that the ODI provides to the investors and the copious inflows into the country from foreign investors has been engaging the attention of the Government and the regulators such as the Reserve Bank of India and SEBI. This has been a topic for discussion in many fora such as HLCC and various committees set up by the Government/ regulators.

Current Scenario:

Currently 34 FIIs / Sub-accounts issue ODIs. This number was 14 in March 2004. The notional value of PNs outstanding which was at Rs.31,875 crores (20% of AUC [1]) in March 2004 has grown to Rs.3,53,484 crores (51.6% of AUC) by August 2007. The value of outstanding ODIs with underlying as derivatives currently stands at Rs1,17,071 crores, which is approximately 30% of total PNs outstanding. The notional value of outstanding PNs, excluding derivatives as underlying as a percentage of AUC is 34.5% at the end of August 2007.

Proposed Measures:

Following consultation with the Government, the following measures are proposed to be implemented urgently:

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 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.

[1] AUC = Assets Under Custody of all FIIs/Sub Accounts

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.

In view of urgency, any comments on the above proposals may be sent to odireporting@sebi.gov.in by 20th October 2007 with the subject line "**Paper for discussion on Offshore Derivative Instruments - Comments"**

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