Funds Hotline

July 04, 2016

SEBI CLOSES DOORS ON PREVIOUSLY ELIGIBLE SUBSCRIBERS TO OFFSHORE DERIVATIVE INSTRUMENTS

- Under the FPI Regulations, ODIs can be issued only to regulated entities. However, under the erstwhile FII Regulations, unregulated 'broad-based' funds with appropriately regulated managers were also eligible to subscribe to ODIs.
- The FPI Regulations had grandfathered all ODI subscribers who have subscribed to ODIs under the FII Regulations (prior to the commencement of the FPI Regulations). SEBI's FPI FAQs permitted such 'Grandfathered Clients' to continue rolling their existing ODI positions and also for taking fresh positions.
- However, SEBI has now revised the FAQs to revoke this position available to Grandfathered Clients for renewing existing ODI positions or entering into fresh ODI positions effective from August 01, 2016. . It now states that (a) fresh ODIs can be issued to those entities which comply with SEBI circulars and FPI Regulations; and (b) Grandfathered Clients who are otherwise not eligible to now subscribe to ODIs, cannot take fresh positions or renew the old positions.

BACKGROUND

The Securities and Exchange Board of India ("**SEBI**") has been taking measures to tighten the norms for subscription to offshore derivative instruments ("**ODIs**") under the Securities and Exchange Board of India (Foreign Portfolio Investors) Regulations, 2014 ("**FPI Regulations**"). Recently, SEBI issued a circular harmonizing the systems and procedures adopted by ODI issuers to comply with the FPI Regulations by aligning the KYC/AML norms for client due diligence and imposition additional reporting and review requirements.[1]

In continuation of its intent to tighten the ODI subscription norms, SEBI has now decided to discontinue the availability of grandfathering to all entities which were registered as clients eligible to subscribe to and hold ODIs issued under the FII Regulations, including entities which were registered but did not have any positions as on January 07, 2014 (i.e. before commencement of the FPI Regulations) (the "**Grandfathered Clients**") from renewing existing ODI positions and taking fresh ODI positions. SEBI has introduced this change on June 29, 2016 by way of a circular[2], giving clarifications on FAQ 70 and FAQ 71 of the SEBI Frequently Asked Questions on the FPI Regulations (the "**Circular**").

ODIs such as p-notes and other classes of over-the-counter derivatives allow the subscriber a streamlined basis for accessing several markets while dealing with very limited number of counterparties. Despite these changes, the ODI route would be preferred over direct investment as a foreign portfolio investor ("**FPI**"), as the latter comes with higher costs and administrative overheads including registration with SEBI, engaging a custodian and filing tax returns in India.

IMMEDIATE IMPLICATIONS

As per the Circular, only those Grandfathered Clients, who comply with Regulation 22 of the FPI Regulations (*i.e.* funds which are 'appropriately regulated') and the SEBI circular dated November 24, 2014 (CIR/IMD/FIIC/20/2014) (the "**November 2014 Circular**"), will be eligible to renew their existing ODI positions and take fresh ODI positions. However, the Grandfathered Clients, who do not fulfil these conditions ("**Unregulated Grandfathered Clients**"), can only continue to hold their existing positions till the date of expiry of such positions or till December 31, 2020, whichever is earlier.

While the Circular states that all ODI positions of Grandfathered Clients will be allowed the benefit of grandfathering until the earlier of the date of expiry of the ODI positions or December, 2020, it is important to note that Regulation 22 (4) of the FPI Regulations allows the ODI positions of Grandfathered Clients to continue until the date of their expiry without any hard stop limit. SEBI should clarify that Regulation 22 (4) of the FPI Regulations has been amended by the Circular in order to bring harmony among the FPI Regulations and the revised understanding on grandfathering.

The Circular will come into effect from August 01, 2016. Accordingly, the Grandfathered Clients have been given a month take measures to ensure continued access by complying with Regulation 22 of the FPI Regulations and November 2014 Circular. *Contrary to this deadline prescribed by the SEBI, we understand that various ODI issuers in the market are rejecting Unregulated Grandfathered Clients from taking fresh positions from July 01, 2016 itself.*

WHAT WAS THE BENEFIT OF GRANDFATHERING?

Regulation 22 of the FPI Regulations provides that Category I FPIs and Category II FPIs (which are directly regulated by an appropriate foreign regulatory authority[3]) are permitted to issue, subscribe and otherwise deal in ODIs. However, those Category II FPIs which are not directly regulated (which are classified as Category II FPI by virtue of their investment manager being appropriately regulated) and all Category III FPIs are not permitted to issue, subscribe or deal in ODIs.

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Under the erstwhile SEBI (Foreign Institutional Investors) Regulations, 1995 (the "**FII Regulations**"), broad based 'unregulated' funds which were managed by appropriately regulated person were eligible to hold ODIs. The FPI Regulations (prospectively) removed unregulated funds as potential holders of ODIs because SEBI preferred such unregulated funds to use the format of direct participation (as FPIs), instead of indirect participation through ODIs. However, SEBI's earlier clarifications in FAQs 70 and 71 (prior to the introduction of the Circular) allowed all Grandfathered Clients to continue dealing in ODIs under the FPI Regulations despite being 'unregulated' funds (which were managed by appropriately regulated person).

Further, under the November 2014 Circular, SEBI had aligned the conditions for subscription of ODIs to those applicable to registration as an FPI under the FPI Regulations, particularly to meet certain eligibility criteria mentioned under regulation 4 of the FPI Regulations (which deals with eligibility criteria for an applicant to obtain registration as an FPI) in addition to meeting the eligibility criteria mentioned under regulation 22 of the FPI Regulations. Accordingly, ODIs can now only be issued to those persons who (a) are regulated by an 'appropriate foreign regulatory authority'; (b) are not resident of a jurisdiction that has been identified by Financial Action Task Force ("**FATF**") as having strategic Anti-Money Laundering deficiencies; (c) do not have 'opaque' structures (i.e. protected cell companies ("**PCCs**") / segregated portfolio companies ("**SPCs**") or equivalent structural alternatives); and (d) comply with 'know your client' norms. Our analysis of the November 2014 Circular can be accessed here https://nishithdesai.com/SectionCategory/33/Funds-Hotline/12/40/FundsHotline/5181/1.html.

Accordingly, all Grandfathered Clients are required to ensure that they are not the resident of a jurisdiction that has been identified by FATF as having strategic Anti-Money Laundering deficiencies; do not have opaque structures such as PCCs/SPCs and comply with the KYC norms (in accordance with the SEBI Circular dated June 10, 2016, CIR/IMD/FPI&C/59/2016).

WHAT NEXT

SEBI has now disallowed unregulated funds (even if managed by a regulated entity) from holding ODIs under the FPI Regulations because it would encourage direct participation by such unregulated entities as FPIs. However, given the lack of guidance on which entities can be considered as "regulated by an appropriately foreign regulatory authority" for the purposes of subscription to ODIs under the FPI Regulations, the revocation of grandfathering will pose new difficulties and introduce more disparities among different ODI issuers.

In some jurisdictions (such as the Cayman Islands), the registration of a fund with a regulatory authority (the Cayman Islands Monetary Authority) could be considered as being "regulated with an appropriate foreign regulatory authority"; whereas, other jurisdictions (such as the United States) allow exemptions from registration with the federal regulator, i.e. the U.S. Securities and Exchange Commission ("**SEC**") which would put many U.S. based hedge funds not required to be registered with the SEC (even though pooling vehicles may be regulated by state level regulators) at a worse off position, though such funds are, in some way, supervised by the SEC.

The removal of the 'grandfathering' provisions would immensely affect the operations for several operators as the Unregulated Grandfathered Clients happen to be the majority investors through the ODI route. As such, hedge funds will not be permitted to renew or extend the existing ODI positions after August 01, 2016, and certain restructuring exercises will have to be undertaken for the beneficial owners to continue holding ODI positions.

Some of the Unregulated Grandfathered Clients, who are currently holding ODI positions, have master-feeder structures. One option for such hedge funds is that they continue to hold the current positions, held through the master funds, till the date of its expiry, and buy new positions through the feeder funds provided, of course, they are appropriately regulated.

If, for some reasons, the feeder funds do not want to hold the ODI positions, they can seek registration from the SEBI as Category II FPI (assuming that such feeder funds are appropriately regulated) and hold the Indian securities directly, by acquiring them from the ODI Issuers.

We, as a legal advisory firm, are trying to explore a possibility of making a representation to the SEBI, with the help of overseas associations, and try to impress upon SEBI that so far as the hedge funds are managed by the appropriately regulated Investment Managers / Investment Advisors ("**Managers**"), and that the said Managers give an undertaking to the SEBI that they will be solely responsible for the due compliance of all the conditions and rules, as prescribed by the SEBI from time to time, such unregulated hedge funds should be allowed to participate in the ODIs. To ensure effective monitoring, SEBI can insist that such Managers should be registered with the SEBI as Category II FPIs, till the time they act as Managers to such unregulated hedge funds. Further, all the disclosure filings prescribed by the SEBI in respect of ODI investments should be done by the Managers.

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. 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. 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. With these norms now a part of the regulatory framework, the Indian regulators should be comfortable with both the forms of market access.

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You can direct your queries or comments to the authors

[1] CIR/IMD/FPI&C/59/2016 dated June 10, 2016

[2] CIR/IMD/FPI&C/61/2016 dated June 29, 2016

[3] Reference may be made to Explanation 1 to Regulation 5 of the FPI Regulations where it is provided that an applicant (seeking FPI registration) shall be considered to be "appropriately regulated" if it is regulated or supervised by the securities market regulator or the banking regulator of the concerned jurisdiction, in the same capacity in which it proposes to make investments in India.

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September 22, 2024