

EY Regulatory Alert

SEBI Consultation paper on access through offshore derivative instruments (ODIs)/ segregated portfolios

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Executive summary

This alert summarizes a recent Consultation Paper (CP)¹ released by the Securities and Exchange Board of India, dated 6 August 2024 in relation to foreign investors accessing the Indian securities markets through segregated portfolios / P-notes / Offshore Derivative Instruments (ODIs) seeking to make sweeping changes to the operational mechanism and reporting requirements for such non-resident investors / ODI issuers.

In summary, the following key changes are being proposed via this consultation paper:

1. The SEBI Circular of 24 August 2023 which mandated granular reporting of ultimate investors in case of FPIs breaching prescribed concentration or size limits is proposed to be made applicable at the ODI subscriber and segregated portfolio level.
2. The current exceptions provided to ODI issuers to hedge their ODI issuances with underlying derivatives is proposed to be withdrawn and ODI issuers would henceforth be required to fully hedge the ODIs issued with the same securities on a one-to-one basis, throughout the life of the ODI.
3. ODI issuers would need to have a separate FPI registration for proprietary investments with the hedging activity effected through a dedicated FPI for this purpose.

The last date to provide comments is 27 August 2024.

¹ Please note that the changes proposed in the consultation paper do not impact FPIs who do not subscribe to/ issue ODIs or FPIs who do not hold Indian investments through segregated portfolios.



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Background

- SEBI has gradually imposed several conditions/restrictions for issuance of ODI. Since permitting issue of ODIs with underlying Indian securities, over the years, with a view to bringing increased transparency of participation in Indian markets. This has resulted in the total value of ODIs with underlying Indian securities vis-à-vis total assets of FPIs in India reducing from a high of almost 45% in 2006-07 to about 2% in the last couple of years.
- Further, in an important development, SEBI's issued a Circular on 24 August 2023 mandating disclosure of beneficial ownership upto the ultimate natural persons in cases of portfolios in excess of USD 3 billion or those having more than 50% of their portfolio in securities of a single corporate group. SEBI has in the Consultation paper stated that the monthly reports suggest that about 40% of ODI positions being held by entities already registered as FPIs which seems to suggest a regulatory arbitrage being available to foreign investor to potentially get around the granular disclosures obligations by taking exposure through the ODI route. A similar arbitrage was also seen in case of segregated portfolios within an FPI wherein the concentration criteria and disclosure requirements were applied at the fund level and not with respect to each segregated portfolio.

Proposal as per the Consultation paper

Proposal 1 - Granular reporting in case of ODI subscribers / segregated portfolios

- In order to remove the regulatory arbitrage, SEBI intends to make the disclosure requirements specified under the circular of 24 August 2023 applicable directly to (i) ODI subscribers and (ii) segregated portfolios of FPIs with sub-funds or separate classes of shares or equivalent structures. Accordingly, the concentration and size thresholds would be applicable directly to ODI subscribers, to be monitored by ODI issuers and their Designated Depository Participants (DDPs)/ Depositories. For computing breach of concentration criteria by an FPI with segregated portfolios, the Indian equity AUM of each of those segregated portfolios shall be considered independently.
- In order to ensure compliance, the following monitoring mechanism has been suggested:
 1. For concentration criteria: To be monitored by ODI issuer and DDP of the respective ODI issuer. In cases of segregated portfolios, the FPI shall be required to provide investment details for each portfolio to the DDP on an on-going basis
 2. For size criteria: ODI issuers, their DDPs and Depositories to monitor threshold across ODI subscribers and group entities (i.e., ODI subscribers with common ownership of more than 50% or common control) taking positions through one or more ODI issuers and group entities registered as FPIs. This would be enabled through:

- a. ODI Issuers: Required to collect information required to ensure clubbing of investments from ODI subscriber(s) prior to issuance/ transfer of ODIs as well as any changes thereto on an ongoing basis and submit to the respective DDP.
- b. DDPs: To collect information received from all ODI Issuers and submit to Depositories.
- c. Depositories: To monitor size criteria in terms of the Circular of 24 August 2023 across FPIs and ODI subscribers.

Where there is a breach of either threshold by an ODI subscriber, ODI issuers will be required to obtain granular disclosures and submit the same to the respective DDPs. In case of non-disclosure, ODI Issuers will need to ensure that defaulting subscribers redeem their ODIs within 180 days and such subscribers shall not be eligible to access ODIs thereafter.

Proposal 2 - Use of derivative by ODI issuers

- While the issue of ODIs with underlying derivatives had been banned from July 2017, ODI issuers were still allowed to hedge the ODIs issued with derivatives on account of certain exceptions provided in the Operational guidelines for FPIs issued in November 2019. It is now proposed to discontinue the current exceptions related to use of derivatives by ODI issuers. ODIs issuers will now only have cash equity/ debt securities/ any permissible investment by FPI (other than derivatives) as underlying and shall only be fully hedged with the same securities on a one-to-one basis, throughout the life of the ODI.
- Existing derivatives positions in the ODI account of the FPI will be required to be redeemed within a period of 1 year from the date on which the final circular is issued in this regard.

Proposal 3 - Issuance of ODIs through separate registration

- Currently, FPIs issuing ODIs are required to seek a separate FPI registration (tagged as ODI) whereas any proprietary investments by the same entity is made through a separate account (tagged as Proprietary). Given that Proposal 2 (above) requires an ODI issuing FPI to be fully hedged with the same securities on a one-to-one basis throughout the life of the ODI, co-mingling of such investments with other investments of the FPI could result in the FPI taking undisclosed net positions on individual securities (across proprietary investments and ODI subscribers), which could pose a challenge in monitoring the one-to-one hedge requirement.
- In order to address the above concerns, it is proposed to mandate issuance of ODIs only through a separate dedicated FPI registration where no proprietary investments would be permitted. Whether this is required to be implemented through a separate entity (with a separate FPI registration) or not, given that the current regulations already prescribe the requirement of a separate registration, needs to be seen.

Comments

From a regulatory reporting perspective, the above proposals are likely to have far reaching impact to both ODI issuers and ODI subscribers that have been accessing the ODI investment route. The requirement for granular reporting by the ODI may cause some challenges among ODI participants who use this route for limited access to India in select securities for cost efficiencies or to mitigate the rigor of local registration. Further, requirement for ODI issuers to hedge their ODI positions on a one-to-one basis with the same securities may have certain tax implications which may require analysis.

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