

## Corpsec Hotline

October 22, 2007

### SEBI'S CLAMP DOWN ON OFFSHORE DERIVATIVE INSTRUMENTS?

Ref: SEBI Paper for discussion on Offshore Derivative Instruments (Participatory Notes).

Dear Sir/ Madam,

Having read and analyzed SEBI's proposed policy measures on Offshore Derivative Instruments ("ODIs") we would like to comment as follows:

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. Since one of the main concerns regarding the issue of ODIs is the anonymity of the investors and source of monies invested through ODIs, we are of the view that such an issue can be resolved by prescribing more stringent and exhaustive guidelines governing the issue of ODIs by FIIs. Such measures should involve stricter KYC norms and reporting requirements and onus should be put on the FII by way of an appropriate undertaking to make sure that FII will disclose the identities of ODI holders if required by SEBI. Alternatively, periodical disclosures by the FIIs of holders of the ODIs can be made mandatory.
2. We understand that the Discussion Paper proposes to eliminate issue of ODIs by sub-accounts. However, we are of the opinion that the proprietary sub-accounts of the FIIs should be allowed to issue ODIs. Our opinion germinates from the fact that most FIIs are investing their money through proprietary sub-accounts which have been organized in jurisdictions with which India has double tax avoidance treaties. Such sub-accounts are directly under the control and purview of the FII and SEBI should accord an equal status to them.
3. We understand that the Discussion Paper limits the investment through ODIs according to the Asset Under Custody ("AUC") of the FII. We feel that SEBI should clarify the meaning of AUC, whether it would include cash under the custody of the FII in India. Further, SEBI should also clarify whether a bid in an IPO by an FII would also be included to calculate the AUC.
4. We understand that the Proposed Measures allows FIIs who are currently issuing ODIs with notional value of P-Notes outstanding as a percentage of their AUC in India less than 40% to issue further ODIs only at an incremental rate of 5% of their AUC in India. We feel SEBI should clarify the period of determination of this incremental rate. SEBI should further clarify how the compliance of this limit will be monitored. We are of the opinion that it should be on real time/daily basis rather than a periodic activity to avoid unnecessary disruptions in the market at the time of disclosure. SEBI should also elucidate the position of newly registrant FII for their investment limit through ODIs.
5. We are also of the view that in order to facilitate and expedite the application process of FII, a Self Regulatory Organization ("SRO") should be established by SEBI on the lines of the proposed Investment Advisors Regulations, wherein before registering with SEBI, the applicants should become a member of such SROs and then make an application to SEBI through SROs.
6. We propose that SEBI should reinstate the deemed FII status accorded to certain regulated Indian entities. This would facilitate them to register their foreign clients as their sub-accounts.
7. We propose that SEBI should do away with the current restrictions on NRIs and OCBs through investing as an FII. This will enable them to invest directly rather than following ODIs route. Further, SEBI should reinstate and effectively allow foreign corporate and individuals to register as sub-accounts.
8. We understand that SEBI's main intention is to allow more investments through the direct route rather than issue of ODIs. In furtherance of the same, we propose that:
  1. SEBI should liberalize the category of FII applicants to include private equity fund, investment companies, etc.
  2. SEBI should make a formal announcement of its intention to allow registration of regulated hedge funds as FIIs.
  3. SEBI should consider recognizing more regulatory authorities such as Cayman Islands Monetary Authority as a recognized regulator.

We believe that the above comments will be helpful for SEBI to introduce a balanced regulatory regime for FII and ODIs thereby paving way for a mature economy.

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Yours Sincerely,

Nishith Desai Associates

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September 22, 2024

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