Corpsec Hotline

October 06, 2008

P NOTES- ALMOST FULL CIRCLE

The Securities Exchange Board of India ("SEBI") today, has taken certain important measures in favor of the Foreign Institutional Investors ("**FII**") as well as the unregistered foreign investors who intend to invest in the Indian Securities market. Looking at the lackluster performance of the capital markets and in order to encourage inflow of foreign capital into India, SEBI has decided to remove the restrictions on issuance of Offshore Derivative Instruments ("ODIs")[1], popularly known as Participatory Notes ("PNs"), which had been imposed on FIIs in October last year.

Background

On October 26, 2007, then SEBI Chairman had announced certain policy measures to curtail the issuance of ODIs by FIIs and in furtherance of which, the following restrictions were imposed on the issuance of ODIs by FIIs:

ODIs with derivatives as underlying

§ FIIs were restricted from issuing/renewing ODIs with underlying as derivatives and existing ODI positions having derivates as underlying assets were required to be wound up by 31st March, 2009.

40% Cap

§ The FIIs who were issuing ODIs with notional value of ODIs outstanding, as a percentage of their assets under custody ("**AUC**") in India as of September 30, 2007, of less than 40% were allowed to issue further ODIs only at the rate of 5% of their AUC in India in any period of 12 months, provided aggregate value of such ODI issuances do not exceed 40% of the AUC.

§ Those FIIs with notional value of ODIs outstanding as a percentage of their AUC in India as of September 30, 2007, of more than 40% could issue ODIs only against cancellation / redemption / closing out of the existing ODIs of at least equivalent amount.

Sub-accounts issuing ODIs

§ Sub-accounts were made ineligible to issue ODIs. Only FIIs could issue ODIs.

Regulated entities

§ ODIs can be issued only to person regulated by an appropriate foreign regulatory authority.

After SEBI Board Meeting October 6, 2008

SEBI's board met today to discuss certain important issues inter alia, the FII regime, wherein it felt that the framework governing the participation of foreign institutional investors in Indian securities markets needs a comprehensive review. Thus, it decided on the following measures:

1. SEBI will put out a detailed consultative paper on this for comments from the public.
2. It also did a limited review of the FII regime in terms of ODIs and it decided to do away with restrictions on issue of ODIs by FIIs against securities, including derivatives, as underlying. We understand that the outcome of this relaxation will have the following:

§ FIIs may now be allowed to issue ODIs with underlying as derivatives such as futures and options.

§ The restriction on FIIs to issue ODIs beyond 40% of their total AUC, may be removed.

However, it is still not clear from the press release whether the restrictions on issuance of ODIs by sub-accounts and the issuance of ODIs only to person regulated by an appropriate foreign regulatory authority will still remain.

NDA VIEW

We understand that the possible explanations of the rationale behind SEBI's rethink on the ODI policy may be:

1. Addressing the current economic scenario- The current economic and market scenario has changed significantly from what it was, when SEBI decided to impose restrictions on issuance of ODIs. Therefore, to address the concerns for liquidity and capital inflow in the market, the regulators were forced to relax the ODI norms.
2. Change in strategy- With new leaderships at SEBI and RBI, we believe that there has been a paradigm shift in the strategy and thinking of the regulators to deal with the capital inflows issues.

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We believe that due to the above measures being taken by SEBI, the relaxations could affect the market players and the economy in the following ways:

1. This relaxation would, at large, benefit the foreign hedge funds intending to invest in the Indian Securities market. After the restrictions imposed in October 2007, these hedge funds could not invest through ODIs and were forced to register directly as FIIs or sub-accounts which was a time consuming process and was proving to be administratively difficult and cumbersome.
2. Further, these relaxations would also provide the much needed leverage for funding their investments in India and worldwide, which may be difficult through direct investments as it requires prior regulatory approval, which may not be extremely forthcoming.

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[1] ODI has been defined to mean "*any instrument, by whatever name called, which is issued overseas by a FII against securities held by it that are listed or proposed to be listed on any recognized stock exchange in India, as its underlying*."

Source: Press Release - SEBI Board Meeting

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You can direct your queries or comments to the authors

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