

Proposal to address regulatory arbitrage with respect to Offshore Derivative Instruments and FPIs with segregated portfolios

1. Objective:

1.1. The purpose of this Board Memorandum is to seek approval of the Board on proposals to address regulatory arbitrage between Offshore Derivative Instruments (“ODIs” – the erstwhile Participatory Notes or P-Notes) and Foreign Portfolio Investors (“FPIs”) with segregated portfolios, with respect to the additional disclosure framework presently applicable to FPIs. The proposals also prohibit use of derivatives by ODI issuing FPIs and mandate a separate registration for ODI issuance by FPIs.

2. Background:

Offshore Derivative Instruments

2.1. ODIs (erstwhile P-Notes) are derivative instruments issued overseas by FPIs against securities held in India as its underlying. While the ODI issuer (i.e. the FPI) remains the owner of the underlying securities, the economic benefits of such holdings get transferred to the ODI subscriber (i.e. the investor). SEBI (Foreign Portfolio Investors) Regulations, 2019 (“FPI Regulations, 2019”) and circulars issued thereunder prescribe certain eligibility conditions with respect to issuance of ODIs, e.g. issuance of ODIs only by Category I FPIs to persons eligible for registration as Category I FPIs, Know Your Client (KYC) norms for subscribers, transfer of ODIs subject to consent of the ODI issuing FPI, monthly reporting requirements, etc.

2.2. In the erstwhile Foreign Institutional Investors regime prior to 2014, Foreign Institutional Investors (FIIs) issued Participatory Notes (P-Notes) to foreign investors who wanted exposure to Indian markets, without the complexities of direct registration with SEBI. P-Notes enabled investors to take exposure in securities of a single listed entity as well as in customized baskets of multiple securities. Also, P-Note issuers could offer such exposure on a leveraged basis. However, in the absence of any registration requirement and the consequent regulatory obligations, P-Notes presented scope for regulatory arbitrage.

- 2.3. The regulatory approach in this regard has been to facilitate investor participation, while reducing opacity. Towards this end, SEBI took many steps including mandating eligibility requirements for issuers, restricting issuance of ODIs referencing derivatives subject to certain exceptions, mandating disclosure of subscriber information, prescribing eligibility conditions for subscribers and mandating ODI issuing FPIs to maintain KYC and Beneficial Owner (“BO”) details of ODI subscribers.
- 2.4. Consequently, the total value of ODIs as a percentage of the total FPI Assets Under Custody (AUC) has dropped from 44.4% at the end of FY 2007 to 2.1% of AUC at the end of FY 2024. Since the notification of the FPI Regulations, 2019, the total value of ODIs as a percentage of the AUC of FPIs has consistently remained below 2.5%. The value of total ODI outstanding as on May 31, 2024 was INR 1.34 lakh crore.
- 2.5. The monthly reports submitted by ODI issuing FPIs also show that out of the total 309 ODI subscribers, 99 (i.e. 32%) are already registered as FPIs. In terms of the value of outstanding ODIs, 40% of the outstanding ODI positions are held by such subscribers.

FPIs with segregated portfolios

- 2.6. In addition, certain FPIs invest through sub-fund structures or separate classes of shares or equivalent structures, with segregated portfolio for such sub-funds, or separate classes of shares or equivalent structures. In terms of the Master Circular for Foreign Portfolio Investors, Designated Depository Participants and Eligible Foreign Investors dated May 30, 2024 (“FPI Master Circular”), FPIs with segregated portfolio(s) are required to provide BO declaration for each fund / sub-fund / share class / equivalent structure that invests in India. Further, in case of addition of any such fund / sub-fund / share class / equivalent structure with segregated portfolio that invests in India, the FPI is required to provide BO information prior to investing in India through such new fund / sub-fund / share class / equivalent structure.
- 2.7. As of July 2024, 85 FPIs have declared that they can have segregated portfolios. However, only 35 FPIs actually hold investments through multiple segregated portfolios with different sub-funds / share-classes. The total AUC

of such FPIs is INR 45,874 crores. Out of these, one FPI has 86 sub-funds/share classes and 8 FPIs have 10 or more sub-funds each having segregated portfolios.

3. Regulatory concerns and proposed solutions

3.1. The regulatory measures as mentioned above in para 2.3 have led to increase in transparency in use of ODIs by foreign investors. The value of outstanding ODIs has also been decreasing over the years as brought out in para 2.4 above. Further, as mentioned above, identification of BOs is already mandated at the level of segregated portfolios held through sub-funds or similar structures. However, potential regulatory arbitrage still exists between investments made through ODIs and segregated portfolios, vis-à-vis regular FPIs.

3.2. The issues arising from such regulatory arbitrage and proposed solutions are as under:

Proposal 1: Applicability of additional disclosure framework directly to ODI subscribers and FPIs with segregated portfolios

3.2.1. Certain FPIs were observed to have concentrated equity portfolio that raised concerns regarding possible misuse of the FPI route for circumventing regulatory requirements such as that of disclosures under Substantial Acquisition of Shares and Takeovers Regulations, 2011 (SAST), or maintaining Minimum Public Shareholding (MPS) in listed companies, or possible circumvention of the stipulations of Press Note 3. In this regard, SEBI has prescribed an “additional disclosure framework” mandating disclosure of granular details of all entities holding any ownership, economic interest, or exercising control in FPIs that fulfil any of the following criteria:

- (a) FPIs holding more than 50% of their Indian equity Assets Under Management (AUM) in a single Indian corporate group (“concentration criteria”);
- (b) FPIs that individually, or along with their investor group, hold more than INR 25,000 crore of equity AUM in the Indian markets (“size criteria”)

- 3.2.2. The “additional disclosure framework” also provides that in case of non-compliance with disclosure requirements, the FPI be required to liquidate its securities and exit the Indian securities market, within prescribed timelines.
- 3.2.3. However, the aforementioned disclosure requirements are directly not applicable to ODI subscribers, i.e. the concentration criteria and size criteria in equity investments are not considered at ODI subscriber level. This enables a foreign investor to potentially get around the granular disclosure obligations by taking exposure through ODIs.
- 3.2.4. The potential for similar regulatory arbitrage is also seen in case of FPIs with segregated portfolios. It may be noted that while FPI Regulations, 2019 provide for registration of funds with segregated portfolios, such funds are required to identify BOs separately for each segregated portfolio. However, in terms of the “additional disclosure framework”, the concentration criteria and disclosure requirements in case of breach of concentration criteria are applied to the fund (i.e. the FPI) and not to each segregated portfolio(s) of such fund.
- 3.2.5. **Proposed solution:** It is proposed to make the “additional disclosure framework” applicable directly to (i) ODI subscribers, and (ii) segregated portfolio(s) of FPIs with sub-funds or separate classes of shares or equivalent structure(s). Accordingly, the concentration criteria and size criteria shall be applicable directly to ODI subscribers. Further, for computing breach of concentration criteria by an FPI with segregated portfolios, the equity AUM of each segregated portfolio shall be considered independently. The FPI issuing the ODIs or having segregated portfolio shall be required to ensure compliance in this regard.
- 3.2.6. To ensure compliance with the above requirements, a monitoring and compliance mechanism is proposed to be put in place providing for, inter alia, collection of subscriber information by ODI issuing FPIs, and submission of subscriber information and holding details by ODI issuing FPIs to Depositories, submission of segregated portfolio level information

by the FPI to the DDP/ Custodian, consequences of non-compliance etc. Further, the consequences of non-disclosure, as prescribed under “additional disclosure framework” shall also apply to the defaulting ODI subscriber(s). Accordingly, the ODI issuing FPIs shall be required to ensure that ODIs held by defaulting subscribers are redeemed within the specified timelines (i.e. 180 days). Further, such defaulting subscribers shall become ineligible to subscribe/ hold any positions through ODIs from any ODI issuing FPI. In case of non-disclosure by FPIs with segregated portfolios, the FPI shall be required to liquidate the said portfolio within the specified timelines (i.e. 180 days).

Proposal 2: Use of derivatives by ODI issuing FPIs

- 3.2.7. Owing to concerns related to use of derivatives by ODI issuing FPIs, SEBI in 2017 prohibited ODI issuance with derivative as underlying, with the exception of those derivative positions that were taken by ODI issuing FPI for hedging the equity shares held by it, on a one to one basis. The Working Group on FPI Regulations (“Working Group”) set up in 2019 also noted SEBI’s concerns regarding build up in derivative segment in India by ODI issuing FPIs on the back of ODIs issuing overseas. Pursuant to the recommendation of the Working Group, an alternative approach, requiring separate FPI registration for hedging the ODIs, was adopted. The alternative approach was further subject to a restricted position limit of 5% of Market Wide Position Limits (MWPL) as against the limit of 20% of MWPL otherwise available to Category I FPIs.
- 3.2.8. Additionally, in cases where an ODI is hedged using derivatives, there are concerns regarding multiple levels of leverage. ODIs allow foreign investors to take a leveraged position in securities market. Further, derivative positions in India allow investors to take a leveraged position in the Indian market. Thus, a leveraged position undertaken using an ODI, which is further hedged using derivatives, may potentially lead to multiple levels of leverage. In any case, ODIs hedged with derivative positions in India leads to shifting of leverage from the ODI issuer-subscriber level overseas to the Indian clearing ecosystem.

- 3.2.9. **Proposed solution:** It is proposed to discontinue the existing exceptions related to use of derivatives by ODI issuing FPIs. ODI issuing FPIs shall be prohibited from (i) issuing ODIs with derivatives as reference/underlying and (ii) hedging their ODIs with derivative positions on stock exchanges. Accordingly, ODIs shall only have cash equity / debt securities / other permissible non-derivative investment by FPI as underlying and shall be fully hedged with the same securities on a one-to-one basis, throughout the life of the ODI.
- 3.2.10. With respect to existing ODIs, it is seen from reports submitted by the ODI issuing FPIs for the month of May 2024 that there are no outstanding ODIs with derivatives as underlying/ reference. Further, only 4 ODI issuing FPIs have outstanding ODIs worth INR 3,075 crores that are hedged with derivatives. In view of the above, existing ODIs, if any, with derivatives as underlying/reference, shall be required to be redeemed within a period of 1 year. Further, existing ODIs with cash positions as underlying but hedged with derivatives shall be required to either be redeemed or hedged with cash positions on a one to one basis, within a period of 1 year.

Proposal 3: Issuance of ODIs through separate registration

- 3.2.11. FPIs are required to obtain a separate FPI registration for use of derivatives for issuing ODIs. Such separate registration is granted in the name of the FPI, suffixed with “-ODI”. Reports submitted by the ODI issuing FPIs, for the month of May 2024, show that 86.33% of the total outstanding ODIs have been issued through such separate dedicated FPI accounts. Further, it is noted that certain FPIs that have taken separate registration for issuance of ODIs still use their proprietary FPI accounts to issue ODIs. Therefore, it is noted that there is no uniform market practice with respect to the use of a separate FPI registration for issuance of ODIs.
- 3.2.12. In proposal 2, it has been proposed that ODIs shall only be referenced to securities other than derivatives, and shall be fully hedged with the same securities on a one-to-one basis throughout the life of the ODI. Where

ODIs are issued by an FPI that holds assets on behalf of other investors, there is a possibility of co-mingling of such investments with the assets held for hedging the ODIs. In other words, the Fund Manager of the FPI may be taking undisclosed net positions on individual securities, against the positions taken across her fund investors and ODI subscribers. This poses a challenge in monitoring compliance with the proposed one-to-one ODI hedge requirement mentioned above, besides keeping the ecosystem open to undisclosed risks.

3.2.13. **Proposed solution:** In order to ensure adherence to one-to-one hedging requirement as referred above, disclosure of positions, and for ensuring monitoring of compliance requirements, it is proposed to mandate issuance of ODIs (other than those with government securities as underlying) only through a separate dedicated FPI registration where no proprietary investments shall be permitted.

4. Discussions in the FPI Advisory Committee

4.1. The above proposals were also discussed in the FPI Advisory Committee in its meeting dated August 12, 2024. The Committee after deliberations recommended the proposals.

5. Public Comments on the Proposal:

5.1. A Consultation Paper soliciting public comments on the above proposals was issued by SEBI on August 06, 2024 and the same is placed at **Annexure A**. With respect to the aforementioned three proposals, nine questions were posed in the Consultation Paper for public response. Total 3305 responses were received from 378 commenters (including DDPs, industry associations, law firms and FPIs). A summary of the public response to the proposals is placed at **Annexure B**.

5.2. Proposal 1 regarding application of “additional disclosure framework” directly to ODI subscribers, sub-fund structures, separate classes of shares and other equivalent structures of FPIs with such segregated portfolios, has received overall positive feedback with nearly 97% of the responses being in favour (strongly agree + agree + partially agree). Several commenters have raised concerns (e.g. compliance with privacy laws) regarding submission of

subscriber information to the DDPs/ Custodians for monitoring purposes and suggested that such subscriber information may directly be submitted to Depositories. The concerns raised and alternative approach suggested by the commenters are found to have merit and accordingly, the proposal with respect to monitoring mechanism has been suitably modified as given in para 3.6.2 above.

5.3. Proposal 2 regarding disallowing the exemptions for use of derivatives for the purpose of issuance of ODIs has also received overall positive feedback with 96% of the responses being in favour (strongly agree + agree + partially agree). However, the proposal to provide a period of 1 year for redemption of existing ODIs (i) with derivatives as underlying/reference and (ii) with derivatives as hedge, has received overall negative feedback with nearly 97% of the responses being against (strongly disagree + disagree) the proposal. However, the commenters disagreeing with the proposal have not suggested any alternative to the proposal.

5.4. Proposal 3 regarding issuance of ODIs only through a separate dedicated FPI registration has also received overall negative feedback with 96% of the responses being against (strongly disagree + disagree) the proposal. The commenters disagreeing with the proposal have highlighted issues related to issuance of ODIs referencing debt securities. Considering that government securities oriented ODIs may not pose a regulatory risk in the context of the issues brought out in this note and in light of the above feedback, the requirement for separate dedicated FPI-ODI registration may not be extended to government securities-oriented ODIs at this stage.

5.5. Other major suggestions/comments received on the consultation paper and SEBI's comments thereon are placed at **Annexure-C**.

6. Proposal:

6.1. In order to address regulatory arbitrage, the Board may consider and approve the following proposals:

6.1.1. To apply the additional disclosure framework directly to ODI subscribers, sub-fund structures, separate classes of shares, and other equivalent structures of FPIs with such segregated portfolios.

- 6.1.2. To specify a monitoring and compliance mechanism providing for, inter alia, submission of subscriber information including holding details by ODI issuing FPIs to Depositories, submission of segregated portfolio level information by the FPI to the DDP/ Custodian, consequences of non-compliance etc.
 - 6.1.3. To mandate ODI issuing FPIs to redeem ODIs held by defaulting subscribers within specified timelines (i.e. 180 days) and specify that such defaulting subscribers shall become ineligible to subscribe/ hold any positions through ODIs from any ODI issuing FPI.
 - 6.1.4. To mandate FPIs, not in compliance with disclosure requirements with respect to any segregated portfolio, to liquidate said portfolio within the specified timelines (i.e. 180 days).
 - 6.1.5. To disallow the exemptions with respect to use of derivatives by ODI issuing FPIs thereby prohibiting ODI issuing FPIs from (i) issuing ODIs with derivatives as reference/ underlying and (ii) hedging their ODIs with derivative positions on stock exchanges. Consequently, ODIs shall only have cash equity / debt securities / other non-derivative permissible investment by FPI as underlying and shall be fully hedged with the same securities on a one-to-one basis, throughout the life of the ODI.
 - 6.1.6. To mandate that existing ODIs, if any, with derivatives as underlying/ reference, shall be required to be redeemed within a period of 1 year from the date of issuance of circular in this regard.
 - 6.1.7. To mandate that existing ODIs with cash positions as underlying but hedged with derivatives shall be required to either be redeemed or hedged with cash positions on a one to one basis, within a period of 1 year from the date of issuance of circular in this regard.
 - 6.1.8. To mandate issuance of ODIs (other than those with government securities as underlying) by FPIs only through a separate dedicated FPI registration, with no proprietary investments under this registration.
- 6.2. The above may be provided by issuance of appropriate circular(s).

7. Proposal to the Board:

7.1. The Board is requested to consider and approve the proposals at Para 6 with suitable amendments as considered appropriate and authorize the Chairperson to make consequential and incidental changes and take necessary steps to give effect to the decisions of the Board.

Encl:

1. Annexure A-Consultation Paper on investment by Foreign Investors through Segregated Portfolios/ P-notes/ Offshore Derivative Instruments (13 pages)
2. Annexure B- Summary of the public comments on 'Consultation Paper on investment by Foreign Investors through Segregated Portfolios / P-Notes / Offshore Derivative Instruments' (1 page)
3. Annexure C- Other major comments/suggestions received from public and SEBI's comments (3 pages)

Annexure A

The consultation paper is available at the following link:

https://www.sebi.gov.in/reports-and-statistics/reports/aug-2024/consultation-paper-on-investment-by-foreign-investors-through-segregated-portfolios-p-notes-offshore-derivative-instruments_85510.html

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