‘Implementing Sebi’s proposal may see a decline in the value of ODI investments’

Existing FPIs using the ODI route to take exposure to Indian securities may be deterred from using the route upon the implementation of the disclosure requirement for ODI subscribers, an expert said.

Neha Joshi
Published • 7 Aug 2024, 07:29 PM IST

ODIs are investment vehicles used by overseas investors for getting exposure in Indian equities or equity derivatives.

The capital markets regulator’s proposal to increase disclosures to address the regulatory arbitrage for foreign investments in Indian markets has led to mixed reactions.

The Securities and Exchange Board of India (Sebi) on Tuesday proposed to harmonize disclosure requirements of Foreign Portfolio Investments (FPIs) by extending the same to subscribers of Offshore Derivative Instruments (ODI) or Participatory Notes (P-notes) and sub-funds of FPI.

ODIs are investment vehicles used by overseas investors for getting exposure in Indian equities or equity derivatives. To be clear, the ODI issuer remains the owner of the underlying securities, the economic benefits of such holdings are transferred to the ODI subscriber.

Disclosure framework

Presently, FPI regulations state that ODIs can be issued by Category I FPIs to eligible persons after compliance with KYC norms. Further the FPI Master Circular of 30 May provides additional conditions

like reporting of suspicious transactions, periodic review of systems, investment limits and monthly ODI reporting, etc.
These disclosure requirements of Sebi are not applicable to ODI subscribers, which enabled a foreign investor to potentially get around the granular disclosure obligations through ODI route, Sebi said in its consultation paper.

It mentioned the potential regulatory arbitrage which exists between investments made through ODIs or FPIs with segregated portfolios. Sebi apprehended possible misuse of the FPI route for circumventing regulatory requirements after noting the concentrated equity portfolios of FPIs in recent years.

Sebi elaborated that as of July 2024, 35 FPIs hold investments through multiple segregated portfolios with different sub-funds/share-classes. Out of these, eight FPIs have ten or more sub-funds each through which segregated portfolios are maintained. One of these FPIs has as high as 86 sub-funds.

A blog by the law firm Nishith Desai Associates of 31 January highlighted that the Adani-Hindenburg fiasco of January last year had pushed Sebi to be on its toes with respect to FPI regulations.

In view of these factors, Sebi proposed to make the disclosure requirements of the August 2023 circular directly applicable to ODI subscribers, and segregated portfolio(s) of FPIs.

"This will obviously mean greater transparency and a see-through mechanism vis-a-vis the ODI subscriber. In terms of the impact, it seems that an ODI subscriber will need to be comfortable with the disclosure requirements as proposed by the Sebi Circular and the transparency that it is seeking to achieve," Ketan Dalal, managing partner of Katalyst Advisors, said.

However, with FPIs being registered in foreign jurisdictions having their own norms and regulations, it was important to see if Sebi requirements are over-reaching these norms, said Archana Balasubramanian, partner at Agama Law Associates.

"Sebi has prescribed ODI subscribers to be eligible for Category I FPI registration. However, this requirement may seek to exclude some existing ODI subscribers from the existing pool and may increase issues for existing FPIs," the lawyer said.

Is additional disclosure the right way?

While disclosure is a good thing from the Indian context, Balasubramanian said such excessive disclosures was unlikely to yield results because that would require making audit and analysis of such disclosures more robust. "Obtaining such disclosures at a group level for global ODI subscribers may pose a significant challenge for the FPI and Sebi to co-relate and accept the disclosures made," she said.

Sebi's paper highlighted that the total value of ODIs as a percentage of the assets under class (AUC) of FPIs dropped from 44.4% (FY07) to 2.1% (FY24). After notification of the FPI Regulations, the total value of ODIs as a percentage of the AUC of FPIs has consistently remained below 2.5%, the paper emphasized.

Kishore Joshi, head of Financial Services & Regulatory Practice at Nishith Desai Associates, said that the implementation of this proposal could see a possible decline in the value of ODI investment.

“Non-Sebi registered offshore entities may not be comfortable in providing the additional information relating to their ownership, economic interest and control on a look through basis to the Indian regulator. Existing FPIs currently using the ODI route to take exposure to the Indian securities may be deterred from using the route upon the implementation of the disclosure requirement for ODI subscribers,” he said.

Referring to Sebi’s data, published by Sebi, Rutu Gandhi, partner, Cyril Amarchand Mangaldas, said that in the event these proposals are implemented, there may be a further decline in the investments through ODIs, and foreign investors may then contemplate coming in through the FPI route instead. Given the implications of the proposal, it is likely that ODI subscribers and FPIs will look to the regulator for some flexibility, relaxation and transition period, Gandhi said.

Use of derivatives by ODI issuers

The use of derivatives for issuance of ODIs was allowed by Sebi in 2017 only for derivative positions taken for hedging the equity shares held by the FPI, on a one-to-one basis. In 2019, Sebi mandated separate FPI registration for hedging ODI subject to taking a derivative position with a limit of 5% of the market wide position limit (MWPL). The available limit to Category I FPIs is 20% of MWPL.

However, Sebi noted that ODIs allow foreign investors to take a leveraged position in the securities market and derivatives in India allow investors to take a leveraged position in the Indian market. “This may potentially lead to multiple levels of leverage,” Sebi noted in the consultation paper.

Sebi thus proposed to prohibit ODI issuers from issuing ODIs with derivatives as reference/underlying and hedging their ODIs with derivative positions on stock exchanges which means ODIs will only have cash equity/ debt securities/ any permissible investment by FPI as underlying and shall only be fully hedged with the same securities on a one-to-one basis.

Balasubramanian said that Sebi’s paper pointed out that only four ODI issuers would be affected. “However, the amount involved is over ₹3,000 crore, because it will require them to redeem within a year through existing ODIs with derivatives as underlying,” she said.

ODI issuance via separate registration

Sebi noted that 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. This posed a challenge in monitoring compliance with the proposed one-to-one ODI hedge requirement mentioned above, besides keeping the ecosystem open to undisclosed risks. To tackle this, it proposed issuance of ODIs only through a separate dedicated FPI registration where no proprietary investments shall be permitted.

Mint is the #1 Source for Comprehensive Union Budget Coverage & Insights. Read More

Catch all the Budget News , Business News , Market News , Breaking News Events and Late... More