

Regulatory Hotline

December 20, 2024

SEBI TIGHTENS NORMS AROUND ISSUANCE OF OFFSHORE DERIVATIVE INSTRUMENTS BY FPIs

The Securities and Exchange Board of India (“SEBI”) issued a circular on December 17, 2024 titled *‘Measures to address regulatory arbitrage with respect to Offshore Derivative Instruments (“ODIs”) and Foreign Portfolio Investors (“FPIs”) with segregated portfolios vis-à-vis FPIs’* (the “Circular”)¹. This follows a Consultation Paper released for public comments on August 06, 2024² (“Consultation Paper”).

The SEBI (Foreign Portfolio Investors) Regulations, 2019 (“FPI Regulations”), along with the Master Circular for FPIs, Designated Depository Participants (“DDPs”) and Eligible Foreign Investors (“Master Circular”), lays down the laws governing FPIs in India. As per the FPI Regulations, an ODI is an instrument issued by an FPI (“ODI issuing FPI”) against securities held by it in India as its underlying. The FPI Regulations also prescribe the eligibility criteria and other conditions applicable to the ODI issuing FPI and the ODI subscriber entities³. The Master Circular, *inter alia*, specifies the conditions applicable to both, the ODI issuing FPI and the ODI subscriber, for the issuance of ODIs⁴. It also elaborates upon the Know Your Customer and other reporting requirements applicable to ODI issuing FPIs.

The (extent of) regulation of ODI issuance by FPIs has been a long-standing topic of debate for SEBI, and thus, this Circular should be seen as an important step towards regulating the ODI subscribers, through the ODI issuing FPIs.

In this hotline, we have briefly covered the updates and modifications introduced by the Circular.

REQUIREMENT OF SEPARATE FPI REGISTRATION FOR ISSUANCE OF ODIs

The Circular stipulates that all ODI issuing FPIs shall have a separate dedicated FPI registration for issuing ODIs, with the term “ODI” as a suffix, thereby requiring ODI issuing FPIs to have two registrations – one for issuing ODIs and another for proprietary investments. The Permanent Account Number (“PAN”) of the entity for both the registrations would be the same and separate PANs would not be required.

An exception from the requirement of a separate dedicated ODI issuing registration has been provided for the issuance of ODIs with Government securities as underlying.

PROHIBITION ON ISSUANCE OF ODIs WITH DERIVATIVES AS UNDERLYING

The Circular prohibits ODI issuing FPIs from issuing ODIs with derivatives as the underlying.

HEDGING OF ODIs

The Circular bars ODI issuing FPIs from hedging their ODIs with derivative positions on stock exchanges in India. Therefore, FPIs will now have to fully hedge their positions with the same scrips on a one-to-one basis, throughout the tenure of the ODI.

ADDITIONAL DISCLOSURE REQUIREMENTS FOR ODI SUBSCRIBERS

Aligned with SEBI’s August 24, 2023 circular⁵ (*and amendments thereof*) (“Granular Disclosure Circular”), which mandated certain objectively identified FPIs to provide granular details of all entities holding any ownership, economic interest, or exercising control in the FPI, on a full look through basis, up to the level of all natural persons, without any threshold, and the proposals set out in the Consultation Paper; the Circular has mandated additional granular disclosures by the ODI subscribers that fulfil certain objective criteria.

Accordingly, ODI subscribers fulfilling any of the two criteria have been mandated to (a) either realign their positions or (b) provide additional granular details of all entities holding any ownership, economic interest, or exercising control in the ODI subscriber, on a full look through basis, up to the level of all natural persons, without any threshold. The below table lists down the two criteria, along with the applicable timelines for re-alignment / disclosure and redemption of positions.

S. No.	Criteria	Time Period for re-alignment of position	Disclosure timeline in case of non-realignment	Consequence of non-disclosure
1	ODI subscriber having more than 50% of its equity ODI positions	10 trading days from	■ Additional disclosure required within 30 trading days from	■ ODI subscriber becomes ineligible to subscribe/ hold

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	through the ODI issuing FPI in ODI referenced to securities of a single Indian corporate group	breach of the date of specified threshold	the expiry of the re-alignment timeline.	any ODI positions through any ODI issuing FPI.
2	ODI subscriber having equity positions* worth more than INR 25,000 crore in the Indian markets.	90 calendar days from the date of breach of specified threshold.	<ul style="list-style-type: none"> ODI issuing FPIs to submit the ODI subscribers' disclosures to depositories within 5 trading days from the date of such disclosure by ODI subscribers. 	<ul style="list-style-type: none"> ODI issuing FPIs to redeem all ODI positions held by such ODI subscriber(s) within 180 calendar days from the date of such ineligibility.

* The Circular elaborates upon the definition of '*equity positions*' to include:

1. Equity ODI positions taken by the ODI subscriber through one or more ODI issuing FPIs.
2. Equity ODI positions taken by ODI subscribers (through one or more ODI issuing FPIs) having common ownership, directly or indirectly, of more than 50% or common control, with the ODI subscriber.
3. Equity holdings of such ODI subscriber as a registered FPI.
4. Equity holdings of FPIs having common ownership, directly or indirectly, of more than 50% or common control, with the ODI subscriber

The responsibility of tracking the breach of the thresholds by the ODI subscriber has been given to the ODI issuing FPIs and the depositories (to whom the ODI issuing FPI would be forwarding the information), who have been instructed to put in place appropriate systems, procedures and mechanisms to ensure compliance with the provisions of the Circular.

The Circular further lays down a list of the categories of ODI subscribers who would be exempt from providing the additional disclosures. Akin to the Granular Disclosure Circular, the list of exempted ODI subscribers includes:

- Government and Government related investors registered as FPIs under Regulation 5(a)(i) of the FPI Regulations;
- Public Retail Funds as defined under Regulation 22(4) of the FPI Regulations;
- Exchange Traded Funds, Pooled investment vehicles and University Funds and University related Endowments fulfilling certain criteria specified in the Circular;
- ODI subscribers breaching the first criteria mentioned in the above table have also been exempted from providing additional information if they comply with certain conditions regarding having equity positions in the apex company of the Indian corporate group.

The Circular provides for the framing and adoption by depositories, DDPs and ODI issuing FPIs, of a detailed mechanism on the working of the additional disclosure requirement, in the form of a Standard Operating Procedure ("**SOP**").

SEGREGATED PORTFOLIO

The Granular Disclosure Circular specifies the two criteria, the breach of either of which mandates either (a) realignment of investments or (b) provision of additional granular information by FPIs.

The first of the two criteria is FPIs holding more than 50% of their Indian equity Assets Under Management (AUM) in a single Indian corporate group. Prior to the release of the Circular, there seemed to be divergent views in the market regarding the applicability of this criteria to FPIs with segregated portfolios, thereby leaving scope for arbitrage. Vide the Circular, SEBI has clarified its position on this point. The Circular provides for the application of this criteria individually to each segregated portfolio(s) of the FPI, effectively meaning that in case of FPIs having segregated portfolio, the investment of each of the segregated portfolio in a single Indian corporate group would be checked individually and in case of any breach, the consequences of the breach would be applicable only to the segregated portfolio breaching the criteria.

NDA VIEWS

Apart from the additional disclosure requirements which will be effective from May 17, 2025, the rest of the provisions of the Circular have been made effective immediately. In this regard, SEBI has provided the ODI issuing FPIs a period of one year from the issuance of the Circular (till December 16, 2025) to comply with (a) the separate registration requirement, (b) the prohibition on hedging of ODI positions with derivatives, and (c) prohibition on issuance of ODIs with derivatives as underlying.

To avoid any confusion on what was permitted and what has been restricted, we should note that earlier, the FPIs could have issued ODIs with derivatives as underlying and hedged such exposure with derivatives position, subject to them (i) having a separate FPI registration, (ii) holding the cash equity during the life of the ODI, and (iii) having a short future position in the same scrip on a one-to-one basis. With the issuance of this circular, ODIs' underlying and hedge positions would have to be in the same security (other than derivatives) on a one-to-one basis. This change should not have much impact on the FPIs since as per SEBI clarification issued on December 18, currently, there are anyways no ODIs with derivatives as underlying.

While the circular clears the air on whether aggregation of direct (FPI) and indirect (ODI) positions should be done to calculate the concentration and size thresholds prescribed by SEBI in its Granular Disclosure Circular, applicability of these norms on ODI subscribers may impact the volume of ODI deals; the key reasons being: (a) for the ODI subscriber - provision of investor data to the regulator of a jurisdiction where they are not directly participating / are registered, confidentiality concerns regarding the sensitive investor data, and in cases of breach and realignment, names of the ODI subscribers being available in public domain; and (b) for the ODI issuing FPI – collecting the requisite details and disclosures from the ODI subscriber and submit to the depositories within the prescribed

SIAC 2025 Rules: Key changes & Implications

February 18, 2025

timeline, and independently validating disclosures of the holdings reported by the ODI subscribers.

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¹https://www.sebi.gov.in/legal/circulars/dec-2024/measures-to-address-regulatory-arbitrage-with-respect-to-offshore-derivative-instruments-odis-and-fpis-with-segregated-portfolios-vis-vis-fpis_89986.html

²https://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

³Regulation 21 of the FPI Regulations.

⁴Part D of the Master Circular.

⁵https://www.sebi.gov.in/legal/circulars/aug-2023/mandating-additional-disclosures-by-foreign-portfolio-investors-fpis-that-fulfil-certain-objective-criteria_75886.html

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