

Funds Hotline

July 19, 2017

SEBI'S DOUBLE (H)EDGED SWORD ON ODI SUBSCRIBERS AND ISSUERS

- SEBI restricts the use of the ODI route, disallowing ODI issuance on derivatives unless held for hedging purposes;
- Purpose seems two-fold – (i) curbing speculative trading in derivatives through the ODI route; and (ii) encouraging direct FPI participation;
- 'Hedging' defined to mean taking one-to-one position in those derivatives, which have the same underlying as the equity shares;
- Existing ODIs grandfathered until their date of maturity or December, 2020, whichever is earlier;
- Compliance officers or equivalent of the ODI Issuers to certify the 'hedging'.

In its continued efforts to restrict the synthetic route to access Indian markets through Offshore Derivative Instruments ("ODIs"), the Securities and Exchange Board of India ("SEBI") has issued a circular¹ prohibiting Foreign Portfolio Investors (the "FPIs" in their capacity as the "Issuers") from issuing ODIs that have derivatives as their underlying unless such exposure is for hedging purposes (the "Circular").

SEBI has been tending to tighten the regulations concerning ODIs and has progressively applied stricter guidelines relating to know your client (KYC) norms for ODI subscribers, transferability of ODIs, reporting of suspicious transactions, periodic view of control systems and modified ODI reporting format.²

While the Circular seems to reflect SEBI's intent to curb speculation in the derivatives market emanating from ODIs, there is a lack of clarity on the hedge basis to be adopted: the circular seems to suggest that the Issuer holding the equity, must be holding the derivatives on such equities (as a hedge), to be able to issue ODIs on such derivatives. A concern is that this expects a delta-one hedging mechanism which may not be reflective of the current practices in constructing and maintaining hedge inventory by institutional Issuers.

BACKGROUND

The SEBI (Foreign Portfolio Investors) Regulations, 2014 (the "FPI Regulations") allow both SEBI registered FPIs and other foreign investors to subscribe to ODIs, if the eligibility conditions are satisfied.³ ODI subscription is allowed on underlying securities which are listed or proposed to be listed on any recognized stock exchange in India or unlisted debt securities or securitized debt instruments.⁴

Issuers have been issuing ODIs on equity, debt and derivatives as underlying securities. Issuers (as FPIs) are permitted to trade in listed derivatives including index futures, index options, stock futures, stock options and interest rate futures.⁵

SEBI had issued a Consultation Paper⁶ on May 29, 2017 to streamline the process of monitoring of ODIs. In the said paper, amidst other proposals, the regulator had proposed to prohibit ODIs from being issued against derivatives except for the purpose of hedging to cease ODI subscription for speculative purposes ("Consultation Paper"). Further, SEBI also proposed to levy a regulatory fee of USD 1000 for a period of every three years on Issuers for each ODI subscriber accessing ODIs through such Issuer.

The Consultation Paper exemplifies SEBI's intent to (i) prevent speculative trading by ODI subscribers through subscription to ODIs on derivatives (not for hedging); and (ii) encourage direct participation through the FPI route.

THE CIRCULAR - ANALYSIS

There seems to be a misalignment between the Consultation Paper, where, apparently, the intent was to prevent pure speculation by ODI subscribers, and the Circular which vaguely clamps the Issuers. The language in the Circular suggests that the Issuer needs to hold the equity shares, for it to issue ODIs on derivatives on such equity shares. It is unclear whether the Issuer needs to issue ODI on equity shares to the same subscriber who is looking to subscribe to ODIs on derivatives on such equity shares.

Further, the Circular requires the Issuer to ensure 'one-to-one' mapping (between the ODI on derivatives and the corresponding equity shares, on which the Issuer holds such derivatives) for satisfying the pre-requisite of hedging. Consequently, it seems that ODIs on index futures and index options as derivatives have completely been disallowed.

Additionally, SEBI has mandated that for fresh issuances of ODIs with derivative as underlying, a certificate by the compliance officer or equivalent, certifying hedging, shall be required and such certificate shall be submitted to SEBI by the Issuer along with the monthly ODI reports.

On account of the prevailing ambiguity in the language of the Consultation Paper vis-a-vis the Circular, following

Research Papers

Compendium of Research Papers

January 11, 2025

FAQs on Setting Up of Offices in India

December 13, 2024

FAQs on Downstream Investment

December 13, 2024

Research Articles

INDIA 2025: The Emerging Powerhouse for Private Equity and M&A Deals

January 15, 2025

Key changes to Model Concession Agreements in the Road Sector

January 03, 2025

The Revolution Realized: Bitcoin's Triumph

December 05, 2024

Audio

Securities Market Regulator's Continued Quest Against "Unfiltered" Financial Advice

December 18, 2024

Digital Lending - Part 1 - What's New with NBFC P2Ps

November 19, 2024

Renewable Roadmap: Budget 2024 and Beyond - Part I

August 26, 2024

NDA Connect

Connect with us at events, conferences and seminars.

NDA Hotline

Click here to view Hotline archives.

Video

"Investment return is not enough" Nishith Desai with Nikunj Dalmia (ET Now) at FIIB event in Riyadh

October 31, 2024

Analysing SEBI's Consultation Paper

combinations can be drawn:

Sr. No. Situation

Possible as per the Circular

1. Issuer A directly holds the equity shares 'X' and the Issuer issues ODI with the underlying as derivative on equity shares 'X' to subscriber 1. Yes.
if Issuer A can demonstrate (through the compliance certificate) that the derivatives on 'X' are to hedge the equity positions on 'X'.
2. Issuer A issues ODIs with underlying as equity shares 'X' to Yes.
subscriber 1 as well as ODIs with the underlying as derivatives on equity shares 'X' to subscriber 1. This should be a clear case of hedging and one-to-one mapping should be easily possible.
3. Issuer A issues ODI with underlying as derivative on equity No.
shares 'X' to subscriber 1 (without holding any direct positions in equity shares 'X') and Issuer B issues ODI with underlying as equity shares 'X' to the same subscriber 1. Issuer A is not holding the derivatives on 'X' for hedging purposes. Hence, hedging would not be possible.
4. Issuer A would issue ODI with underlying as derivative on Grey.
equity shares 'X' to subscriber 1 and issue ODI with underlying as equity shares 'X' to subscriber 2. This should be possible because the Issuer may demonstrate that it is holding the derivatives on equity shares 'X' for hedging purposes. However, one-to-one mapping may be difficult for the Issuer.
5. Issuer A issues ODI with underlying as derivative on equity Grey.
shares 'X' to subscriber 1 and subscriber 1 itself holds the equity shares 'X' This might not be possible as Issuer A doesn't hold the equity shares, though Subscriber 1 took the position in the ODI with an objective to hedge its direct equity exposure.

CONCLUSION

Taking into consideration that different Issuers employ different strategies and techniques to hedge their equity exposure, no restrictions should be imposed on how Issuers hedge their equity exposure or their dealings with the securities that form their overall hedge inventory.

The ODIs issued by the FPIs either with equity or derivatives as underlying cannot be associated with the amount of inflows in or outflows from the Indian securities market since hedging on one-to-one basis has become an obsolete technique for the institutional ODI issuers.⁷ The SEBI Circular doesn't take the said development into account.

The condition prescribed in the Circular that the existing ODIs with derivatives as underlying, must be liquidated by the end of 2020 or by the ODI's date of maturity, whichever being earlier, has become a cause of concern for the ODI subscribers. We understand that the foreign investors have sought a three-month extension to roll over their July positions since liquidating all the contracts at once would create huge volatility in the stock market, considering that the derivative contracts usually have a maturity period of a month.⁸ However, SEBI has not taken any decision on the same.

While the intention of SEBI (from the Consultation Paper) seems clear that it aims to curb speculative trading in the derivatives market, the Circular seems unclear in the approach towards meeting this purpose by imposing the onus on the Issuers. The contrary view is that imposing the onus on the Issuers would be more effective as SEBI has more regulatory control over these registered FPIs than the investors who indirectly route their investments through them.

– Kishore Joshi, Richie Sancheti & Prakhar Dua

You can direct your queries or comments to the authors

¹ SEBI Circular, dated July 7, 2017, available at http://www.sebi.gov.in/legal/circulars/jul-2017/guidelines-for-issuance-of-odis-with-derivative-as-underlying-by-the-odi-issuing-fpis_35266.html

² SEBI Circular June 10, 2016, available at http://www.sebi.gov.in/sebi_data/attachdocs/1465796415786.pdf

³ Regulation 22 of SEBI (FPI) Regulations, 2014, available at http://www.sebi.gov.in/sebi_data/attachdocs/1389083605384.pdf

⁴ Additionally, SEBI had issued another Circular dated June 29, 2016 where it was mandated that the ODI subscribers could continue to subscribe to ODIs under the FPI regime, subject to two conditions, viz., compliance with Regulation 22 of FPI Regulations and meeting the eligibility criteria as laid down in the SEBI Circular dated November 24, 2014 along with the norms notified by SEBI from time to time.

⁵ NSDL FPI Monitor, available at <https://www.fpi.nsdl.co.in/>

⁶ Available at http://www.sebi.gov.in/reports/reports/may-2017/consultation-paper-on-streamlining-the-process-of-monitoring-of-offshore-derivative-instruments-odis-participatory-notes-pns-_34977.html

⁷ International Swaps and Derivatives Association Inc., *Working Group on Foreign Investment in India*, March 9, 2010. Also, see SEBI's Annual Report 2008-09, available at http://www.sebi.gov.in/sebi_data/attachdocs/1289364867230.pdf

⁸ Available at http://www.business-standard.com/article/economy-policy/foreign-banks-said-to-look-for-relief-from-india-s-derivatives-rule-117071101225_1.html

DISCLAIMER

The contents of this hotline should not be construed as legal opinion. View detailed disclaimer.

This Hotline provides general information existing at the time of preparation. The Hotline is intended as a news update and Nishith Desai Associates neither assumes nor accepts any responsibility for any loss arising to any person acting or refraining from acting as a result of any material contained in this Hotline. It is recommended that professional advice be taken based on the specific facts and circumstances. This Hotline does not substitute the need to refer to the original pronouncements.

This is not a Spam mail. You have received this mail because you have either requested for it or someone must have suggested your name. Since India has no anti-spamming law, we refer to the US directive, which states that a mail cannot be considered Spam if it contains the sender's contact information, which this mail does. In case this mail doesn't concern you, please unsubscribe from mailing list.

